DIRECTORS & OFFICERS LIABILITY EXPOSURES

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Directors & Officers Liability Exposures
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Chapter 1
Introduction and Course Overview

IRMI has teamed up with WebCE to bring you this quality continuing education course.

This Web CE 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 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 2 describes the general nature of corporations and discusses the functions that directors and officers perform within corporations.
- Chapter 3 sets forth the common law duties owed by directors and officers to the corporations they serve. These duties, collectively known as “fiduciary duties,” include (1) loyalty, (2) obedience, and (3) due care.
- Chapter 4 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 5 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 6 sets forth the most common defenses available to corporate directors when claims are made against them.
- Chapter 7 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 8 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 9 discusses four additional types of securities class action claims made against directors and officers of corporations. These include claims associated with (1) auction rate securities, (2) subprime lending, (3) private equity operations, and (4) the Bernard Madoff investment Ponzi scheme.

- Chapter 10 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) ERISA stock-drop claims, and (4) regulatory and criminal proceedings.
- Chapter 11 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 12 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 13 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 14, 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.

Upon successful completion of this course, you will be able to:

1. Explain the general nature and purpose of corporations and identify the functions served by directors and officers within corporations.
2. Discuss the three key common law duties that directors and officers owe to corporations.
3. Describe the major federal securities laws which can give rise to director and officer liability.
4. State and illustrate the most important statutes (other than those pertaining to securities liability) that can subject directors and officers to claims.
5. Analyze the most important legal defenses that directors and officers have available to them when claims are asserted against them.
6. Describe the essential nature of securities class action claims.
7. Define and analyze the major sources of securities class action claims against directors and officers, including claims from: financial restatements, initial public offerings (IPOs), change-of-control situations, stock option backdating, auction rate securities, subprime lending, the Bernard Madoff investment Ponzi scheme, and private equity operations.
8. Analyze the various types of parallel proceedings, including derivative, op-out, ERISA stock drop claims, and regulatory/criminal proceedings.
9. List and provide details concerning the four major underwriting factors considered by insurers in underwriting and pricing D&O coverage.
10. List and discuss the so-called “general methods” of preventing D&O claims.
11. Provide examples of and discuss the various methods of controlling D&O losses that pertain to corporate governance.

Chapter 2
The Corporation and the Functions of Directors & Officers

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.

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 to (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 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 thrift (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 cannot be purchased by the public. Rather, the shares of private companies tend to be held by a small group of persons, 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.

The Functions of Directors and Officers

Management of a corporation is entrusted to its board of directors, the members of which are elected by the shareholders. 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); and
- 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 include 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, which normally consist 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:

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

Chapter 2 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, Worker 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. 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.

3. The Flat Corporation board of directors has a typical committee structure. The committee most likely responsible for board member compensation is the:
    a. Audit committee.
    b. Compensation committee.
    c. Nominating committee.
    d. Shareholders committee.

Answers to Chapter 2 Review Questions

1. a. If a corporation fails, shareholders are not liable for any remaining debts owned to the corporation's creditors.
2. c. Directors are elected by shareholders.
3. b. Recommending compensation levels for company management and board member compensation is a responsibility of the compensation committee.

Chapter 3
Common Law Duties of Directors & Officers

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 "caselaw" 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.

The Four Fiduciary Duties

The four 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 3.1.

Exhibit 3.1 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 association with the company, makes sales calls on behalf of his 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, 510 (Del. Ch. 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

The duty of obedience relates to directors' and officers' responsibility for assuring that their personal conduct conforms to applicable law. Adherence to the duty of obedience also obligates directors to limit their corporation's conduct to the powers conferred on the corporation by its charter and as imposed by law. "Law" includes not only the common law and statutes of the state of incorporation, but also federal and state statutes, rules, and regulations that control their duties and the corporation's 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, which describes the purpose, location, and other details pertaining to the organization.)

Directors are not only liable for their own *ultra vires* acts but 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 Directors & Officers Liability

Although claims against directors and officers for breaching the duty of obedience have received increased attention over the last quarter century, they historically have not 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, in the past decade, 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.

Recent Settlements

In today's environment, directors and officers can no longer feel safe from threats of personal liability exposure, even under the most comprehensive insurance program. As evidenced by some recent 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. For 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. Most recently, in 2007, five former directors of Just for Feet paid a total of $41.5 million in conjunction with their service at the company, an amount that exceeded the combined Enron and WorldCom director-funded settlements. (In this case, the plaintiffs alleged massive accounting irregularities in conjunction with the firm's financial statements that vastly overstated the company's financial results, including booking unearned receivables as income.)

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 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. The adequacy of such deliberative processes, as distinct from the result of their deliberative process, is the focus of the duty of care.

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 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 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 poor decision because Corporation B's operations are unprofitable, the directors will not be held liable for violating the duty of due care because it took reasonable measures and performed a thorough evaluation, prior to making the decision to purchase Corporation B.

Failure To Make a Decision

With respect to board inaction that leads to a corporate loss, compliance with a director's duty of care 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 B's offer.

The Duty of Good Faith: An Emerging Fiduciary Duty

In recent years, a fourth common law duty has begun to emerge, known as the duty of good faith. This doctrine was introduced in a case known as *In re Walt Disney Derivative Litigation,* 907 A.2d 693, 755 (Del. Ch. 2005), and is discussed later in this course under "A Notable Derivative Claim" in Chapter 10. 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 3 Review Questions

1. 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.
2. 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.

Answers to Chapter 3 Review Questions

1. c. 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.
2. c. 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.

Chapter 4
Federal Securities Liability

Chapter 4 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.

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 or not 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 major falsification, compared to a less important one. 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 and 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 10b-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 Section 10b-5: The Prohibition against "Insider Trading"

This section of the law 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 non-public information (also referred to as *asymmetrical knowledge*) about the company.

Here is an example of insider trading, which would be prohibited under Section 10b-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, Global Crossing bankruptcies (and 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 4.1.

Exhibit 4.1
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 chief executive officers and chief financial officers of public companies *personally participate* in preparing the firm's financial statements and *personally certifying* 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.

Chapter 4 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.

Answers to Chapter 4 Review Questions

1. c. The purpose of the 1933 Act is to ensure the availability of complete and reliable information about securities being sold to the public.
2. d. Insider trading is the trading of stock by a person with access to nonpublic information.

Chapter 5
Liability under Other Types of Statutes

While more than half of all claims against directors and officers are based on either violations of securities or employment-related laws, a substantial number of claims against directors and officers are also brought under statutes prohibiting various other types of conduct. Such statutes are noted in Exhibit 5.1 below, and a number of the more important ones are discussed in Chapter 5.

Exhibit 5.1
Statutes Giving Rise to Director & Officer Liability

Anticompetitive and Unfair Business Practices

- The Sherman Act
- The Clayton Act
- The Robinson-Patman Act
- The Uniform Trade Secret Act,
- The Federal Trade Commission Act

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 (ERISA) of 1974

Failure To Withhold and Remit Federal Taxes

- The Internal Revenue Code

Direct Corporate Contributions to Candidates for Office in Federal Elections

- The Bipartisan Campaign Reform Act of 2002 (a.k.a. The McCain–Feingold Act)

Hazardous Workplace Conditions

- The Occupational Safety and Health Administration Act (OSHA)

Exhibit 5.1 Statutes Giving Rise to Director & Officer Liability (cont.)
Environmental Pollution • The Clean Air and Water Acts • The Comprehensive Environmental Response Compensation and Liability Act (CERCLA) • The Resource Conservation and Recovery Act (RCRA) **Fraud in Connection with Government Contracts** • The False Claims Act **Bribery of Foreign Officials** • The Foreign Corrupt Practices Act **Employment Practices** • The Equal Pay Act of 1963 • Title VII of the Civil Rights Act of 1964 • Age Discrimination in Employment Act (ADEA) of 1967 • The Pregnancy Discrimination Act of 1978 • Older Workers Benefit Protection Act of 1990 • The Civil Rights Act of 1871 (as amended by the Civil Rights Act of 1991) • Americans With Disabilities Act (ADA) of 1992 • The Family and Medical Leave Act (FMLA) 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 Act and the Clayton Act, violation of which can subject corporate directors and officers to liability. The Sherman Act 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. The Clayton Act 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.

Predatory Price-Cutting Activities

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

Disclosure of Trade Secrets

Trade secrets are protected by common law and by federal statute. The Uniform Trade Secret Act codifies common law principles of liability for improper disclosure of trade secrets. The 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 to 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

Trademarks are protected from unauthorized use by federal (i.e., the Lanham Act) and state statutory and common law. A trademark is infringed 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 *Polo Fashions, Inc. v. Branded Apparel Merchandising, Inc.*, 592 F. Supp. 648 (D. Mass. 1984), the court found the corporation's president personally liable for the corporation's trademark infringement because he was the moving force behind the sales of the merchandise that infringed the plaintiff's trademark.

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 attorneys' fees. For example, if a plaintiff suffered $1 million in losses that qualified as a "pattern of racketeering," under the treble damages provision he/she could potentially collect three times this amount, or $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. The Act imposes a fiduciary duty on the both the investment adviser and the investment company, requiring that they charge reasonable compensation for their services. The 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.

In recent years, directors and officers, even though they may have no day-to-day responsibilities for managing employee benefit programs, are, increasingly being 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 that they had (2) 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, 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 IRS. Most cases against individual directors and officers turn on whether such individual is a "responsible person" under the Act—usually defined as someone who has significant control over the company's finances.

Liability for Political Contributions

The Bipartisan Campaign Reform Act of 2002, better known as the McCain–Feingold Act, regulates the financing of political campaigns. Even though corporations may not make contributions in connection with federal elections, they may establish what are known as "political action committees" (PACs), which are permitted to raise voluntary contributions from a "restricted" class of individuals. This class consists of managerial employees and stockholders, and their families. These funds may be used to support federal candidates and political committees, either through independent expenditures or through contributions to candidates. A PAC is limited to a maximum contribution of $5,000 to a candidate committee. Directors and officers are exposed to liability for violation of the McCain-Feingold Act in conjunction with campaign funding activities of the corporation.

Liability for Safety Violations

Under certain circumstances, directors and officers may be held liable as "employers" for violations of the Occupational Safety and Health Administration Act (OSHA). OSHA 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 Act.

Environmental Liability

An emerging 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

The Comprehensive Environmental Response Compensation and Liability Act (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 Pharmaceutical and Chemical Co.,* 810 F.2d 726, 743 (8th Cir. 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

The Resource Conservation and Recovery Act (RCRA) establishes a comprehensive hazardous waste management system. The 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 D&O exposure for treble damages in claims against directors and officers. The 1986 amendments to the False Claims Act 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. Among other things, the 1986 amendments provide for: (1) the recovery of treble damages, (2) the reimbursement to the private citizen of reasonable attorneys' fees and costs, and (3) 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 participates in the case, or (4) 25–30 percent if the Department of Justice does not participate.

Any company doing business with the U.S. government has potential exposure under the Act. For example, companies that obtain government loans or loan guarantees, participate in federal grant programs, receive farm subsidies, obtain federal entitlements, receive Medicaid or Medicare claim payments, or otherwise perform contract or subcontract work on government projects are potential *qui tam* targets.

Case-in-point: in June 1991, Northrop Corporation agreed to pay almost $9 million to settle a *qui tam* suit brought by two former employees who alleged that the company had defrauded the government by falsifying test results regarding air-launched cruise missiles.

Liability in Connection with Bribery of Foreign Officials

The Foreign Corrupt Practices Act 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 the Corporation to ship its products into Country A. 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.

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. In fact, such claims comprise around 20 percent of all lawsuits filed against directors and officers and 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 far less than 5 percent of the total dollar value of director and officer liability claim payments.

Although the trend is moving away from holding directors and officers personally liable under most federal antidiscrimination legislation, some federal laws and courts still impose personal liability on directors and officers for discrimination.

Coverage under Stand-Alone Policies

A minority of directors and officers liability policies exclude coverage for employment-related claims. However, most contain no such exclusions. Nevertheless, most large corporations purchase separate employment practices liability insurance (EPLI) on a stand-alone basis, which is intended to function as primary insurance when employment-related claims are made against directors and officers. 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 Course 6 in this series: “Employment Practices Liability Exposures and Insurance Coverage,” which treats this subject in depth.

Chapter 5 Review Questions

1. An unfair and anticompetitive business practice may violate any of the following federal acts, *except:*
    a. Clayton Act.
    b. Federal Trade Commission Act.
    c. Occupational Safety and Health Administration Act.
    d. Robinson-Patman Act.
2. None of the three pharmaceutical companies making zeta blocker pills has 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, profitable level. An agreement of this type violates the:
    a. Foreign Corrupt Practices Act.
    b. Older Workers Benefit Protection Act of 1990.
    c. Racketeer Influenced and Corrupt Organizations (RICO) Act.
    d. Sherman 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'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 (ERISA) of 1974?
    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. Disposal of hazardous waste.
   b. Whose waists the material was removed from.
   c. Generation of hazardous waste.
   d. Transportation of hazardous waste.

Answers to Chapter 5 Review Questions

1. c. The Occupational Safety and Health Administration Act (OSHA) deals with hazardous workplace conditions.
2. d. The Sherman Act prohibits conspiracies in restraint of trade.
3. d. The CEO was the moving force behind the sales of merchandise that infringed the Beavers' copyright.
4. c. 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 asset.
5. b. RCRA imposes "cradle to grave" regulation requiring detailed records regarding the generation, transportation, and disposal of hazardous waste.

Chapter 6 Primary Defenses to Corporate Liability

Chapter 6 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.

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 recent 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:

> … 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

There are five preconditions that 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* (the rule does not apply where directors either abdicate their functions or simply fail to act);
- The directors were *disinterested* (i.e., that 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*; and
- The directors' conduct was *not an abuse of discretion*.

The Business Judgment Rule: A Case Study

The following scenario provides an example of how the business judgment rule might be raised as a defense to a claim of liability against a corporation's directors and officers.

The Scenario

In 2010, a multinational pharmaceutical company ("MNPC") is considering the acquisition of a small drug manufacturer ("SDM"). For the past 10 years, SDM has been developing a formula that completely relieves the symptoms of arthritis. Initial clinical trials have been highly successful. In addition, there have been no side effects associated with the drug during any of the trials. Although the Food and Drug Administration (FDA) has not yet approved the drug for distribution, approval appears likely within the next year, pending continued success during a second round of trials. MNPC's own scientists have tested the formula, as have independent scientific consultants hired by MNPC, and both are convinced of the drug's effectiveness. Given these positive results, the MNPC's board deliberates the acquisition during parts of six board meetings, over a 9-month time span. During these deliberations, MNPC considers waiting for final FDA approval, following the second round of trials, prior to making an offer to buy SDM. However, after many hours of analysis, the board reaches the conclusion that if MNPC does wait until FDA approval, SDM's acquisition price would increase substantially.

In 2011, MNPC offers to pay the founder of SDM $50 million to acquire her company, which she accepts. In developing its offering price, MNPC hired investment bankers to determine a basis for valuing the company, given the potential sales and profits of SDM's arthritis formula. The investment bankers estimated that if MNPC waited until the drug received final FDA approval, the founder of SDM would have been able to command a much higher price, probably around $250 million. The directors and officers presented the potential acquisition, and all of the facts surrounding it to shareholders, who approved the acquisition overwhelmingly.

In 2012, a year after the acquisition, the FDA refuses to release the drug for distribution to the public. In explaining its refusal, the FDA cites safety concerns; during a second round of clinical trials, there were two deaths among volunteers who took the drug. The drug could potentially be modified to eliminate the risk of such complications. But to do so, MNPC's scientists believe it would require removing a key ingredient that would all-but-eliminate the drug's effectiveness. Given the prospect that the new drug will never be allowed on the market, the $50 million acquisition price for SDM is now far in excess of the firm's actual value. When the FDA's ruling is released to the public, MNPC's share price drops from $40 to $20, resulting in a flood of lawsuits by MNPC's shareholders against its directors and officers.

The Business Judgment Rule as a Defense

This scenario offers an example of how the business judgment rule would likely provide an effective defense to a claim of liability against MNPC's directors and officers. Here was a case in which the directors and officers took a calculated risk in deciding to acquire SDM. Although the outcome of the decision was disastrous, the process by which the decision was made appears to have fallen within the boundaries of the rule, because:

- The directors made a *business decision* (the loss resulted from an active decision, rather than from a failure to act);
- The directors were *disinterested* in the transaction (none had any individual, personal financial stake in the acquisition);
- The directors were *informed* in making their decision (independent scientific and investment banking advice was sought prior to the acquisition; the decision to acquire SDM sooner rather than later was based upon the fact that the acquisition price would be substantially higher if MNPC waited until FDA approval);
- The directors acted in *good faith* (there were no ulterior motives associated with the decision); and
- The directors' conduct was *not an abuse of discretion* (the directors and officers were within the bounds of their authority under the corporation's charter, to make the acquisition).

Since the scenario fulfilled all five of the preconditions for raising the business judgment rule as a defense, it is likely that in a real-world situation, the directors and officers would have been absolved of liability for the financial consequences of the decision to acquire SDM.

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.

For dissent to qualify as a defense, a director must have voted against the action, as opposed to merely abstaining from the vote. When directors disagree with improper action taken by a board, the minutes should reflect such dissent, and it is a director's responsibility to make sure they do so.

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. (In other words, if, for example, 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. (Ratification, as referred to here, could, for example involve a vote by shareholders to accept a buy-out offer from another corporation, at a specific price per share.)

Such ratification must be the free, voluntary, and informed act of the shareholders. For a complete defense, ratification by 100 percent of the shareholders following full disclosure of all material facts may be necessary.

Chapter 6 Review Questions

1. 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.

2. 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 6 Review Questions

1. c. Complete and accurate minutes would record not only the board's final decision but also the directors' personal positions relative to the decision.

2. b. 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.

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Chapter 7
Securities Class Action Claims

Securities class actions are, by far, the type of claim in which the largest amount of damages are asserted against and paid by corporate directors and officers. This chapter will describe the nature of these 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 a class action claim, 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 $5,000 in value probably could not find a lawyer to represent him/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, 2010. When XYZ reports its actual earnings to the 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. 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). Chapters 8 and 9 of this course list and describe seven 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 (i.e., lawyers who bring lawsuits on behalf of shareholders who allege losses), began devising and using highly questionable methods of bringing securities class action claims against major corporations.

Anatomy of a "Shake-Down": 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 are now serving time in jaim for their offenses.)

Specific PSLRA Reforms

The most important changes implemented by the PSLRA was that it limited the frequency with which "professional plaintiffs" could serve as "lead plaintiff," by limiting such persons from serving in that capacity more than 5 times in 3 years. The law also placed restrictions on the extent to which law firms who 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, the statute has not been successful in curbing the abuses associated with securities class action lawsuits. Nor did it reduce 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 many large class action lawsuits—including securities 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 the Act

The Act 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 (e.g., Madison County, Illinois), 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

The Act gives federal courts—rather than state courts—jurisdiction over certain class actions: (1) in which the amount in controversy exceeds $5 million, and (2) 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.

The Act also contains a provision giving courts greater scrutiny over class action settlements, especially those involving coupons. 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, in an infamous Alabama class action involving Bank of Boston, the attorneys' fees exceeded the monetary award to the 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 the Act 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

Since CAFA was enacted in 2005, its impact on the number and outcome of securities class action claims remains uncertain. Additional years must pass before an accurate assessment of the law's actual effect can be made.

Securities Class Action Claim Data

This section provides a brief recap of securities class action claim and settlement data since 1996.

The Correlation between Claim Filings and Industry Sector

Exhibit 7.1, below, indicates the extent to which securities class action claims are correlated with specific industries. For example, in 2008, nearly one-third of all new claim filings were made against firms in the financial sector. In addition, during the 2000–02 period, a high percentage of claims were filed against technology and communications companies. Lastly, in 2002, 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 7.1
Securities Class Action Claims Correlated to Specific Industries

S&P 500 Securities Litigation Heat Maps™

Percent of Companies Subject to New Filings*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Basic Materials	2.4%	0.0%	0.0%	0.0%	0.0%	3.4%	0.0%	0.0%	0.0%
Communications	8.3%	17.4%	22.7%	4.8%	2.3%	4.8%	2.3%	6.5%	4.8%
Consumer Cyclical	5.5%	4.1%	5.3%	5.5%	2.7%	9.5%	2.8%	5.9%	2.9%
Consumer Non-Cyclical	4.5%	5.6%	9.7%	7.4%	8.4%	9.6%	7.1%	9.3%	7.4%
Energy	0.0%	3.3%	19.2%	0.0%	4.0%	0.0%	0.0%	0.0%	0.0%
Financial	4.2%	1.4%	18.3%	6.3%	13.6%	5.0%	0.0%	9.4%	32.6%
Industrial	2.9%	0.0%	6.1%	4.5%	4.5%	4.6%	1.6%	1.6%	3.2%
Technology	11.4%	14.8%	5.3%	3.6%	3.6%	5.4%	9.3%	0.0%	6.0%
Utilities	5.9%	5.9%	34.3%	2.9%	6.1%	3.0%	0.0%	3.2%	3.3%
All S&P 500 Companies	**5.0%**	**5.6%**	**12.0%**	**4.8%**	**6.0%**	**6.0%**	**3.2%**	**5.2%**	**9.2%**

Legend	0%	0% – 5%	5% – 15%	15% – 25%	25%+

* The chart is based on the composition of the S&P 500 as of the first trading day of each year.

Industries are based on *Bloomberg* sector classifications.

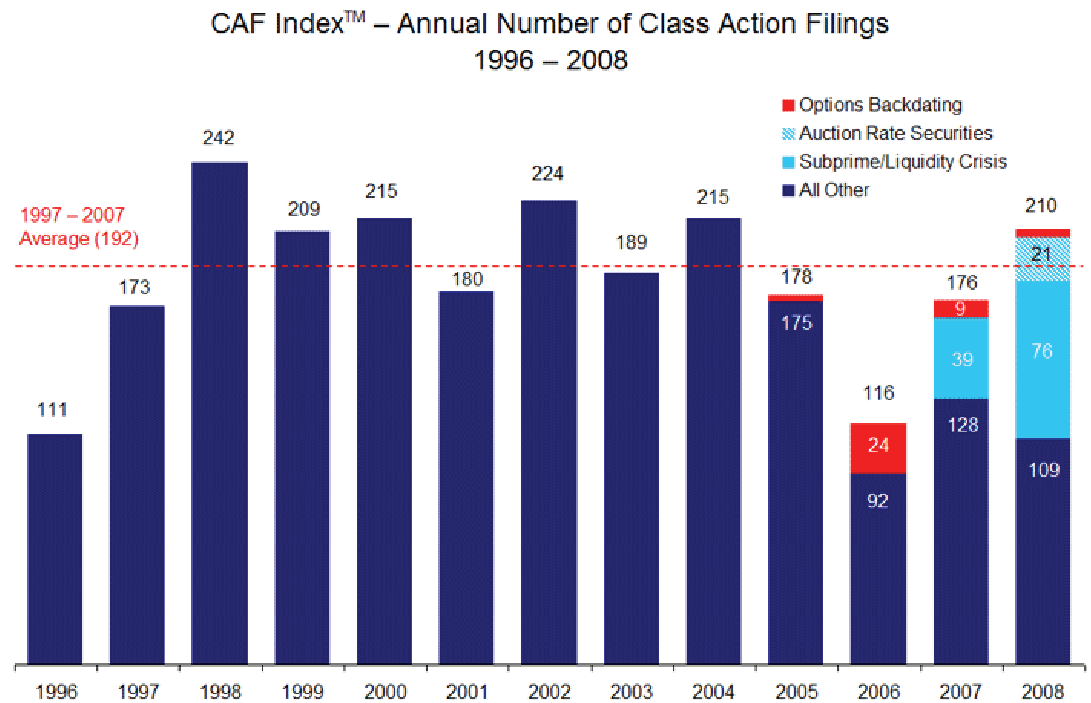
Percent of Companies Subject to New Filings equals the number of companies subject to new securities class action filings in federal courts in each sector divided by the total number of companies in that sector.

Source: Cornerstone Research; "Securities Class Action Filings; 2008: A Year in Review"

Historical Class Action Claim Filing Data

Exhibit 7.2, below, provides a recap of overall class action claim filings since 1996. In 2008, as expected, there was a huge spike in filings against companies in the finance sector. Specifically, over 120 of the claims—representing nearly 50 percent of all filings—were against a company in the finance sector.

Exhibit 7.2
Securities Class Action Claim Filings Since 1996



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

Source: Cornerstone Research; "Securities Class Action Filings; 2008: A Year in Review"

Exhibit 7.3 below contains a list of the 10 largest class action claims of all-time.

Exhibit 7.3
Top 10 Shareholder Class Action Settlements

Ranking	Company	Year	Total Settlement (in millions)
1	Enron Corp.	2008	$7,242
2	WorldCom, Inc.	2005	$6,158
3	Cendant Corp.	2000	$3,561
4	Tyco International	2007	$3,200
5	AOL Time Warner Inc.	2006	$2,650
6	Nortel Networks (I)	2006	$1,143
7	Royal Ahold, NV	2006	$1,110
8	Nortel Networks (II)	2006	$1,074
9	McKesson HBOC Inc.	2008	$1,043
10	UnitedHealth Group	2008	$ 925

Source: NERA Economic Consulting; 2008 Trends in Securities Class Actions

Chapter 7 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. Contribute to global warming.
   c. Violated federal law.
   d. Were unnecessarily risky and increase 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, ten 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 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. As of the end of 2008, 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 7 Review Questions

1. a. 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.
2. d. 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. b. 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
4. c. Enron's total settlement exceeding $7.2 billion has the dubious honor of being the largest to date.

Chapter 8
Specific Situations Giving Rise to Securities Class Action Claims: Part 1

Chapter 8 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.

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 Restatement Claims

In recent years, 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 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.
- Appliance maker Sunbeam inflated its 1997 earnings by $71 million to make it appear that the company's operating results were improving. This ruse was blessed by the firm's regular auditor but was uncovered when the board of directors brought in outside auditors.
- 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.

There are two key questions that should be asked in conjunction with any financial restatement: (1) What events caused the need for a restatement? (2) 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.

- 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.
- Whistle-blower'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

The 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 booking of sales to customers as "final," despite the fact that the customer had the right to return the goods within 60 days.

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 the buyer understates the extent of the new entity's 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 readily estimable, 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 or failing to write off obsolete inventory.

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

Initial public offerings (IPO)-related claims allege various types of wrongdoing in conjunction with the way in which investment bankers (also known as 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 have been infrequent since that period, if these economic conditions return, similar volumes of IPO-related litigation could again emerge.

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 percent to 20 percent of the proceeds that were raised in the process.

In this situation, the investment banker might, for example, issue and sell 60 million shares of Company X's stock in the open market at a price of $20 per share. Customers typically include a variety of mutual funds, banks, pension funds, insurance companies, brokerages houses, corporations, and individual investors. Assuming the investment banker was able to sell all of Company X's shares, the IPO would have raised a total of $120 million ($60 million shares x $20 per share = $120 million), $100 million of which would go to Company X to fund its expansion program. The remaining $20 million would go to the investment banker as a fee for their services. This is essentially how an IPO works.

Types of IPO Claims

There are three distinct IPO claim types.

Laddering or Tie-In Agreements

Laddering claims allege that investment bankers forced buyers of shares in IPOs to agree that, as a condition of receiving a significant number of shares, the buyers would purchase additional shares in the “after-market,” immediately following the issuance of shares in the IPO. These purchases are intended to markedly increase demand for the stock, ultimately resulting in a substantial rise in the market price of the stock immediately after it is sold to the public and begins trading on one of the major stock exchanges. (It is in the investment bankers’ best interest if such shares rise in price after they are issued, for two reasons. First, a price increase indicates that the IPO was a “success.” Second, investment bankers sometimes buy IPO shares for their own accounts, which will benefit them when the share price rises.) This approach is consistent with data provided by Dan A. Bailey, a prominent D&O attorney, who found that in 1999, the average first-day price gain of IPOs was 60 percent and in 2000, the average gain was approximately 55 percent. In effect, so-called IPO laddering claims assert that the investment bankers coerced buyers of the IPOs into buying additional shares, so as to increase the market price of the shares, immediately after the shares went public.

Failure To Disclose Commissions

The second type of IPO-related claims allege that IPO investment bankers received larger compensation from investors than was revealed in the IPO prospectus, a fact that rendered the prospectus false and misleading. (The prospectus is the document that describes the nature of the company in which buyers are investing. A prospectus also discusses the details surrounding the arrangements that the company has made with investment bankers, pertaining to sales of its stock.) These undisclosed, additional commissions in effect served as “kickbacks” from certain investors in exchange for being allowed to buy a larger-than-usual number of shares in the IPO. Claims were made against the investment bankers by parties who received fewer IPO shares than others, because they were unaware of and therefore did not make “kick back” payments, in return for additional shares.

Conflicts of Interest

The third type of claim associated with IPOs involves conflict of interest allegations. Such claims assert that there were conflicts between the research analysts (a group of supposedly objective securities analysts who recommended to the public that they buy shares in the IPOs) and the investment bankers who actually sold shares in an IPO to the public. The conflicts of interest resulted from the fact that the research analysts and the investment bankers worked for the same company! To increase the market price for a new issue, investment bankers promoted the stock through their research analysts by citing the analysts’ seemingly independent, objective evaluations and recommendations. Ultimately, this had the effect of increasing the market price for the new securities to the detriment of the buyers of these securities.

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: their duty to shareholders to ensure that they receive a fair and maximum price for their shares, their duty to the corporation to protect its best interests as a corporate entity, and 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 buy-out.

Frequent Claimants

Accordingly, directors/officers frequently become targets of litigation, when someone becomes dissatisfied with their 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.

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 in such a claim can be enormous, and therefore the settlement value may be large.

Approval of Friendly Takeovers

The directors of the company being acquired, who approve an acquisition of their company, also are frequently sued by shareholders who allege that the directors failed to make an informed decision regarding the adequacy of the purchase price. Or, 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 and as a result, sue the prior directors and officers for the injury caused to the company. For example, after acquiring Company A, Company B may discover that the 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 frequently results 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.

Mismanagement (Following the Acquisition)

Directors and officers of the acquiring company can also incur liability in connection with management of the acquired company. 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, merit 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 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, 2008, 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, 2010, 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. This, in turn, would allow him/her to exercise the option at a price far higher than the price at which it was granted (in this case $25 per share). 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, 2008, the CEO were given a 4-year option grant that covered the period from January 1, 2006, to January 1, 2010. But in this situation, the market price of the stock was $15 on January 1, 2006, 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, 2010, when the stock was selling for $35, would be $2 million ($35 share price minus $15 exercise price multiplied by 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 did trigger investigations and lawsuits were the fact that a number of companies: (1) did not disclose such practices to shareholders and the general public, and that in some instances (2) director/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 one-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, CEO could seek an options grant of 1 million shares at a price of $15, knowing that the stock will rebound shortly, therefore increasing his chances of realizing a profit on the eventual sale.

Chapter 8 Review Questions

1. In reviewing Vic Corporation’s financial records, an independent auditor discovers that the value of a major corporate asset was greatly overstated because corporate accountants failed to apply accounting standards acceptable to the auditor. This type of disagreement, which will probably result in a financial restatement, is referred to a(n):

    a. Accounting error.

    b. Audit exception.

    c. Routine correction.

    d. Special situation.

2. 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. Causes 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.
3. Buff Warrant, a wealthy investor, purchased the maximum number of shares of Ytech's 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 a larger stake 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.
4. 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
5. 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.

6. 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 8 Review Questions

1. b. An exception in an audit occurs when an auditor disagrees with the accounting treatment of a certain item.
2. a. Accurate reporting of this liability would result in lower reported earnings or a higher reported loss for the period.
3. d. IPO-related claims in cases like this typically allege that the investment bankers received larger compensation from investors tan the IPO prospectus revealed, rendering the prospectus false and misleading.
4. a. Potential plaintiffs include shareholders of the corporation, the persons or entity making the bid, creditors, and regulatory agencies.
5. d. Their current management status is irrelevant, as the claim alleges their prior mismanagement.
6. c. Failure to disclose stock option backdating practices to shareholders and the general public is - illegal.

Chapter 9
Specific Situations Giving Rise to Securities Class Action Claims: Part 2

Chapter 9 will discuss four additional situations that can give rise to claims against corporate directors and officers. These include claims from: (1) auction rate securities, (2) subprime lending, (3) private equity operations, and (4) the Bernard Madoff investment Ponzi scheme.

Claims from Auction Rate Securities

During 2008, a number of lawsuits were filed against the directors and officers of major investment banks and brokers, in conjunction with financial instruments known as "auction rate securities" (ARSs). Banks and brokerages pitched ARSs to corporations and to high net worth individuals as safe, but higher-yielding alternatives to cash—that were just as liquid as cash (or so investors were led to believe).

What are Auction Rate Securities?

An auction rate security (ARS) is essentially a long-term bond, issued by a corporation or a municipality. However, ARSs differ from bonds in one crucial respect. Rather than paying a fixed rate of interest for a long period of time (e.g., a minimum of 10 years 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. Accordingly, at each Dutch Auction, holders of an ARS have the opportunity to sell the security.

Issuers/borrowers benefit from this arrangement because ARSs can provide them with long-term financing, but at substantially lower rates compared to traditional, long-term bonds.

What Went Wrong?

Beginning in February of 2008, auctions for these securities began to "fail" due to a lack of bids, something that investors were told was highly unlikely to happen. The problem arose largely because the four largest investment banks that sold ARSs (Citigroup, UBS AG, Morgan Stanley, and Merrill Lynch) refused to act as bidders of last resort, as they had done previously. Until recently, these and other financial institutions had stepped in with their capital to prevent failures when bidding faltered. But these firms grew unwilling to commit their money to ARSs after suffering billions in credit losses and mortgage write-downs stemming from the subprime mortgage collapse (yet another source of D&O claims and a situation that will be discussed later in this course).

What Were the Consequences of Failed Auctions?

The failure of the auctions did not mean that the ARSs went into default. This is because the issuer continued to pay interest on them. However, the lack of liquidity caused by the auction "failure" meant that investors' money was essentially frozen in their accounts, an event that few anticipated, because, as already noted, the extreme liquidity of these instruments was one of its major selling points.

What Is the Basis of the Lawsuits?

The basis of the class action lawsuits (against the investment banking firms that promoted ARSs to investors) was that the ARSs were sold as short-term instruments, when, in reality, they turned into long-term ones. Since ARSs were marketed as highly liquid, short-term investments, the lawsuits alleged losses based on investors' inability to cash out on an as-needed basis, the essential selling point of ARSs.

Claim Counts

According to *The D & O Diary* as of February 1, 2009, a total of 21 class action lawsuits involving ARSs had been filed against broker dealers, security issuers, and mutual funds, among others. (There were also a significant number of single plaintiff securities lawsuits filed on behalf of preferred shareholders and subordinated debt holders.)

Claims from the Subprime Mortgage Lending/Credit Crisis

The litigation wave that was triggered by subprime lending and the accompanying credit crisis began with the filing of the first subprime mortgage-related lawsuits in early February 2007. Two years later, in February of 2009, claims continue to be made and there are no signs that they are subsiding. The following discussion provides a brief description of how and why the credit crisis began and, most important, an overview of the nature and types of D&O liability exposures and claims that the crisis has produced.

Step One: Subprime Loans

The mortgage lending/credit crisis originated with subprime real estate loans. These loans carry interest rates that are substantially above the prime mortgage loan rate. The prime rate is the lowest rate available and is offered to borrowers with credit scores that are considerably higher than average. In contrast, subprime loans are made to borrowers who pose a high credit risk, either because they have: (1) a low credit score or (2) a high debt-to-income ratio. Another important characteristic of subprime loans is the fact that the vast majority were made with low down payments (e.g., less than 5 percent of the property's value) and, in some cases, no down payments.

Traditionally, subprime loans constituted only about 5 percent of the typical bank's mortgage loan portfolio. However, beginning around in 2002, and continuing through 2005 (a year in which approximately 20 percent of all real estate loans could be classified as subprime), banks began sharply increasing the proportion of subprime loans they made. In fact, during the 2003–05 period, total, outstanding subprime debt outstanding increased nearly by a factor of three, from $332 billion to $1.3 trillion.

What Fueled the Demand for Subprime Loans?

Two factors were instrumental in driving the demand for subprime loans: (1) initially low "teaser rates" and (2) rapidly rising real estate values.

The Lure of "Teaser Rates"

The first 2 to 3 years of the typical subprime loan amortized at relatively low interest rates and consequently required low monthly payments. However, after this period, the initially low "teaser rate" would reset to a much higher rate, which, of course, produced a significantly higher monthly payment. For example, initially, a subprime loan might have amortized at an interest rate of only 4 percent for the first 2 years. However, after this period, it would reset to 12 percent. An interest rate shift of this magnitude might, for example, have taken an initially affordable monthly payment of $1,000 and increased it to an unaffordable $2,500 per month.

Skyrocketing Values and the Real Estate "Gold Rush"

The demand for subprime rate loans was also being driven by rapidly increasing real estate values. Beginning around 1996, the general level of home prices began to rise faster than the historical norm, which, for years had tended to approximate the general level of inflation. By 2000, this trend began accelerating to an even greater extent, so that by 2002, on a national basis, real estate was appreciating far faster than the inflation rate. Moreover, in certain areas of California, Florida, Arizona, and Nevada, home prices were rising by as much as 35 percent per year. This trend produced a virtual "gold rush" mentality, whereby residential real estate became a "sure thing" investment. Even if the eventual rate on a subprime loan became onerous, many borrowers were told and also gambled on the possibility that, given skyrocketing home values, it would be a simple matter for them to refinance their loan on much more favorable terms—well before the regular, subprime rate actually kicked in.

What Went Wrong?

Beginning in mid-2006, subprime loan rates began to reset en masse. Accompanying the resets were sharply higher monthly payment amounts, which, in turn, touched off a wave of loan defaults by buyers who could now no longer afford to make such payments.

At virtually the same time, nationwide real estate prices first stopped increasing, then started to drop, and in many areas began to plummet by up to 25 percent on an annualized basis—especially in states and cities that, during the 2002–2005 period, had witnessed similarly meteoric increases in value. Unfortunately, subprime borrowers were now unable to "escape" from their predicaments by either refinancing at a lower rate or by simply selling their property. This was because in virtually all instances, given falling real estate prices, their outstanding loan balance now far exceeded the value of their home (a fact that resulted not only from plummeting home values, but also because, as noted earlier, virtually all subprime loans were made with no, or very low down payments). Given such circumstances, even if a subprime borrower could find a buyer for their property, the proceeds of such a sale would, in nearly all cases, be vastly insufficient to pay off their existing loan.

Rate Resets and Plummeting Values Combine To Trigger a Foreclosure Wave

The combination of rate resets and plummeting real estate values produced a surge of foreclosures. The end-result of the entire process was that banks began losing money because the expected cash flows from the subprime loans were not forthcoming. Even worse was the fact that given the elevated number—and geographical concentration of defaults—when banks began repossessing homes, these properties became extremely difficult to unload, even at fire sale prices. In many instances, entire neighborhoods were dotted with foreclosed homes that sat empty, making them not only challenging to resell, but also exposing the homes to systematic looting and vandalism, a fact that further reduced their value. The bottom line for banks with extensive subprime loan portfolios: the true market values of such properties are, in virtually all cases, vastly below their outstanding loan values, regardless of whether they had been foreclosed on or not.

Cash-Out Refinancing: the Final Nail in the Coffin

Exacerbating the-above described circumstances was the fact that during the late 1990s and early 2000s, millions of people with existing home loans began borrowing heavily against the equity in their homes. When real estate values began to sink by mid-decade, they too often found themselves with negative equity positions in their homes (as did subprime borrowers). These circumstances also contributed to additional defaults and consequent foreclosures, even among mortgage loans that were not of the subprime variety. This was because any time the outstanding balance of a loan exceeds the value of the underlying property, there is a much greater probability of default.

Step Two: Securitization

The second factor underlying the subprime mortgage lending/credit crisis was the fact that many of these risky loans were "securitized."

What is Securitization?

Securitization is a process whereby periodic cash flows from a given source are pooled, packaged, and sold to investors, usually in the form of bonds. Accordingly, groups of subprime mortgage loans were bundled together to create what are referred to as collateralized debt obligations (CDOs), more commonly known as mortgage-backed securities (MBSs).

Under such arrangements, the subprime loans were packaged 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. Such loans were typically sold by the original lender (i.e., the banks), to a trust entity, which packaged them into bonds, then sold them to individual and institutional investors through an investment banking firm.

By 2006, approximately 63 percent of all subprime loans were being sold and packaged in this fashion. When the defaults began, the value of the underlying bonds began to plummet because the collateral backing the bonds (i.e., the periodic cash flows in the form of monthly payments from the subprime loans), was substantially lower than anticipated given the wave of loan defaults, and thus were insufficient to pay the interest mandated by the bonds.

The Role of the Credit Rating Agencies

A key "enabler" of the securitization process was the credit rating agencies responsible for rating these MBSs. Specifically, Standard & Poor's, Moody's, and Fitch were the leading firms that routinely assigned investment grade ratings to mortgage backed securities backed by subprime loans. These and other rating agencies bear a significant part of the responsibility for the wave of eventual MBS defaults, because the agencies badly underestimated the probability of default by subprime borrowers. By the end of 2007, it was estimated that investors around the world had lost in the neighborhood of $300 to $400 billion on MBS investments.

Step Three: Credit Derivatives

The third factor underlying the subprime mortgage lending/credit crisis was the fact that a vast mountain of credit derivatives, were written to insure these collateralized debt obligations. Derivatives are financial contracts, whose values are a function of some other asset, known as the "underlying asset." These underlying assets might include shares of stock in a specific company, a group of residential mortgages, bonds, or indexes (i.e., the Standard & Poor's 500 index). The purpose of derivatives is to reduce the risk of economic loss for holders of the underlying asset on which the derivative is based, a process known as hedging. Conversely, derivatives can be used by investors to earn profit if the value of the underlying asset moves in the direction they anticipate, a process known as speculating.

How Do Derivatives Operate?

An MBS holder, by means of a credit default swap, one common type of derivative, could buy what is, in effect, an insurance policy that would pay off the investor if the MBS defaulted. In theory, such arrangements, make perfect sense because they facilitate the operation of the credit markets. By having such derivatives available, they encourage investors to buy MBSs, while allowing them to "hedge their bets," protecting them in the event the underlying bond defaults.

Credit Derivatives: What Went Wrong

Unfortunately, too many of the entities that "wrote" such derivative contracts, which, as noted above, really amounted to insurance policies, did not have sufficient capital to pay off these obligations once the MBSs began to default on a grand scale.

Derivatives: AIG's and Bear Stearns' Undoing

When the entity that provides such insurance protection—after it has collected its upfront premiums—doesn't have the money to pay the insured buyer in the case of a default, the insurance policy is essentially worthless. Because it wrote so many of these contracts, but didn't have the capital to back them up, the investment banking firm Bear Stearns became insolvent. It "survived" only because what remained of the company was bought by JP Morgan. Bear Stearns literally could not go bankrupt because the trillions of dollars in credit default swaps on its books would have been wiped out had it been allowed to do so. If Bear were allowed to default on these obligations, all the banks and other financial institutions that had purchased "swaps" (i.e., insurance on MBSs) from Bear would, in effect, be uninsured. This, in turn, would have required these banks and financial institutions to write-down billions of dollars in MBS assets that they had been carrying at much higher values, because they could claim to have been insured against potential losses associated with these MBS assets.

The same fate would have befallen American International Group Inc. (AIG) had the United States government not stepped in and injected approximately $150 billion in capital into AIG; money that was required to, in effect, "cover" AIG's losing bets on mortgage-backed securities that were secured by subprime loans. The problem with AIG was not its property, casualty, and life insurance operations. Rather, the problem was that, as of June 30, 2008, AIG had written swaps on other corporate bonds, and worse, mortgage-backed securities, that carried with them the potential to pay as much as $441 billion if they all defaulted. As the value of these bonds continued to fall (and in many cases, default), AIG was forced to post additional capital to back these bad bets, collateral which it didn't have.

Derivatives "on Steroids": Enter the Speculators

What took the problems created by derivatives to an entirely new and wholly toxic level was the fact that in addition to those who sought them for protection (i.e., by hedging) because they owned the underlying MBSs or other bonds, speculators began buying derivatives simply because they believed, or at least thought, there was a reasonable probability, that many of the MBSs would default, a scenario that could produce substantial profits—despite the fact that these speculators held no ownership interest in the underlying bonds themselves.

For example, assume that an individual or institutional investor thought that a particular bond was in jeopardy because the underlying collateral (i.e., the subprime mortgages backing it) were nearly worthless. This situation would present a high risk of default and the consequent inability of the bond issuer to pay back its bondholders. Under such conditions, the investor or institution could speculate by buying, and paying premiums for, credit default swaps on this bond, which would pay the full face amount of the bonds if they did actually default. Conversely, if the investor or institution believed that the bond was solid as a rock, such investors/institutions could offer insurance to a speculator, who held the opposite opinion about the bond's ability to pay its bondholders.

The Bottom Line?

On a worldwide basis, it has been estimated that a total of $62 trillion in these derivative contracts/"swaps" remains active. And as long as subprime mortgage defaults persist on an enormous scale (as they have continued to do, through February 2009), losses will continue to pile up for both "writers" of these swap contracts who don't have the capital to pay off all of their bad bets, but also for "buyers" of these contracts who are losing money when the bonds do, in fact, default, yet were "insured" by firms that have insufficient capital to actually pay the losses as promised by the terms of the "swap."

Despite the estimated $62 trillion figure, no one really knows the true extent of the exposure from "swaps" because the derivatives market is completely unregulated. Accordingly, every estimate of this exposure is just that—an estimate. No wonder super investor Warren Buffett has called derivatives "weapons of financial mass destruction."

What Are the Leading Claim Allegations against Corporate Directors and Officers?

A wide variety of claim sources have arisen from the subprime mortgage lending/credit crisis.

Borrowers Suing Lenders (and Related Parties)

As of early 2009, a total of approximately 156 lawsuits have been filed against lenders and their directors and officers.

Suits Based on Fraudulent Lending Practices

Suits have alleged that subprime borrowers were victimized by various fraudulent lending practices and that the lenders, along with their directors and officers, had overseen and sanctioned these procedures. For example, in June 2007, the lender NovaStar paid $5 million to settle a borrower class action suit alleging that NovaStar failed to disclose to its prospective borrowers that it paid "yield spread premiums." These are premiums paid to mortgage brokers (i.e., persons who solicit loans for buyers of property and then arrange a loan with a bank or other financial institution). When the brokers negotiated interest rates that were higher than the rate for which a borrower actually qualified, they received these “yield spread premiums.” For instance, if a buyer qualified for a prime loan at 6 percent but was sold a subprime loan at a 12 percent substantially rate, the mortgage broker received a commission representing a portion of the difference between these two rates.

Additional lawsuits against the directors and officers of these lenders alleged that they engaged in other fraudulent lending practices, including that they: (1) made misleading statements regarding loan disclosures and documents, (2) fabricated credit information, (3) created schemes in conjunction with real estate appraisers to inflate property values, (4) overcharged buyers on closing costs, and (5) paid illegal kickbacks and referral fees to title insurance agencies.

In many instances, the lawsuits assert that lenders simply failed to explain that after a 2- to 3-year period, the initial monthly payment would double or even triple.

Discrimination Suits

A number of suits claimed that African American and Hispanic customers were particular targets of risky and inappropriate loans which violated the Fair Housing and Equal Credit Opportunity Acts. Most frequently, the suits alleged that such buyers were “steered” into high interest subprime loan, when, in fact they actually qualified for prime loans, or at least those with substantially lower rates than those charged under subprime arrangements.

“Equity Stripping” Suits

Numerous consumer protection actions have been brought by various state attorneys general alleging that mortgage lenders induced customers to take out loans that they clearly could not afford. These have been termed “equity stripping” loans, whereby minority and elderly customers were saddled with high fee/high interest loans, that were intentionally designed to reduce their home equity positions to zero and, in addition, were obviously unaffordable given the borrowers’ relatively limited incomes. Similarly, such suits have also been brought against the directors and officers of major financial institutions, such as Lehman Brothers and Merrill Lynch, on the theory that they encouraged and assisted lenders in predatory lending schemes, knowing they could package and sell these loans in the form of bonds, as discussed earlier.

Investor Lawsuits

The second major group of plaintiffs that emerged from the sub-prime mortgage lending/credit crisis were investors who purchased the mortgage-backed securities backed by subprime loans that later defaulted. The initial target of such lawsuits was the directors and officers of the financial institutions from whom these MBSs were purchased.

Additionally, investors have sued the major credit rating agencies who rated such instruments as investment grade. This is especially true since a number of agencies admitted to having worked with the investment banking firms that issued the mortgage-backed securities, making sure that they did, in fact, carry investment grade ratings even when any rational analysis would have indicated otherwise.

Shareholders Lawsuits

The next group of plaintiffs was shareholders in companies whose businesses were heavily involved in subprime lending and securitization. Given the crushing financial losses these companies suffered as a result of such activities, the share prices of these companies dropped precipitously, thereby paving the way for securities class action claims.

Numerous class action suits were brought against mortgage lenders (e.g. Countrywide Financial), financial institutions that served as underwriters of mortgage-backed securities (e.g., investment banking firms such as Merrill Lynch and Lehmann Brothers), providers of credit enhancement insurance (e.g., AIG and Bear Stearns), the credit rating agencies (e.g., Moody's, Standard & Poor's) and, of course, the directors and officers of all of these organizations.

Lawsuits by Shareholders in "Collateral" Industries

A number of other industries have also been severely impacted by the subprime lending/credit crisis, despite the fact that these industries did not actually loan funds for subprime mortgages or were involved at any stage of the securitization process.

Home Builders

Home builders have been particularly hard-hit because the level of new home building since 2007 has plummeted. This has resulted in the country's major home builders sustaining huge losses since early 2007, a fact that ultimately impacted the shares of such companies' stocks.

Unrelated Industries

In addition, there are companies completely outside the financial sector or home building sectors whose investment portfolios/balance sheets are laden with MBSs or other troubled assets that have been impacted by the sub-prime/credit crisis. The interesting question is how far outside the financial sector claims against these kinds of companies will spread in the future.

Claims from the Bernard Madoff Investment Ponzi Scheme

In December 2008, it was revealed that Bernard Madoff, investment fund manager and former chairman of the NASDAQ stock exchange, had engaged in a massive investment Ponzi scheme that had defrauded investors of an estimated $50 billion. (Ponzi schemes operate by obtaining money from new investors, which is then used to pay off existing investors when they seek to withdraw monies from the investment. Eventually, however, Ponzi schemes collapse when cash inflows from new investors cease, or, when withdrawal requests from existing investors become so large that they cannot be met with the funds that are available.) What is important from the standpoint of this course is the fact that Madoff's "activities" have already generated, and will likely continue to generate, substantial claims against a host of corporate directors and officers in a variety of industries.

The Scheme, in Brief

Madoff accepted money from numerous individuals and institutional investors (many of whom were charitable foundations). In return for a fee, Madoff invested and managed these investors' funds.

The Myth

By means of what he described as a unique hedging strategy, what are known as option contracts, Madoff produced investment returns that, over more than two decades, consistently exceeded the return yielded by the S&P 500 Index—or so it appeared. Even in years during which the Index was down sharply, Madoff nevertheless managed to produce positive, and usually double-digit returns on the monies he invested for his clients. Those returns were not only fairly high but also consistent; in fact, he rarely had a losing month and never reported a single losing year. Rather than offer suspiciously high returns (e.g. 20 to 40 percent annually) to all comers, Madoff offered solid but remarkably steady returns to an exclusive clientele, in both up and down markets.

Other Professionals Doubt the Returns

A longtime friend of Madoff's noted that "his rate of return ...was never attention-grabbing, just solid 12–13 percent year in, year out." Robert Ivanhoe, chairman of the real estate practice of the law firm Greenberg Traurig, added that Madoff increased his allure by actually refusing to accept some potential investors as his clients.

But perhaps the most telling indictment of Madoff's deception was the written testimony submitted to the U.S. House of Representatives Committee on Financial Services by financial analyst and fraud investigator Harry Markopolos. In it, Markopolos noted that "The biggest, most glaring tip-off that [Madoff's claimed investment strategy] had to be a fraud was that [he] only reported 3 down months out of 87 months, whereas the S&P 500 was down 28 months during that time period. No money manager is only down 3.4 percent of the time. That would be equivalent to a major league baseball player batting .966 and no one suspecting that this player was cheating."

The Reality

In truth, the profits Madoff claimed were nonexistent. The monthly statements he issued to his clients were, in fact, fraudulent because following Madoff's arrest, it was revealed that none of the monies he claimed to have invested during the previous 15 years were actually used to purchase various stocks, bonds, or options (as noted in his clients' monthly statements). No one knows how much of his clients' money he really lost, although the criminal complaint against Madoff alleges that he lost more than $60 billion through the operation of his scheme. What is indeed certain is that these statements wildly exaggerated Madoff's claimed successes as a money manager. But he was able to create the appearance of such consistent profits for the following two reasons.

A Continuing Inflow of New Investors—and New Money

First, he continuously added new investors to his existing pool of clients. As a result, when his current investors sought to withdraw funds, he was always able to provide them with the money they requested, but only because it came from new investors—not from profits earned on their funds.

Charitable Trusts: a Source of Stability

Second, what also aided Madoff was that a high percentage of the monies he managed belonged to charitable trusts, foundations, and endowments. By law, such trusts are required to withdraw at least 4 percent of their funds annually (to maintain their tax exempt status). On the other hand, it is also rare for them to withdraw substantially more than that percentage in any given year. Thus, Madoff would never be faced with a large "drawdown request" from even a single foundation's account. Therefore, by targeting charities, Madoff substantially reduced the threat of large withdrawals from any single client.

The Unraveling

What eventually unraveled his scheme, was that during 2008, the S&P 500 index dropped by approximately 40 percent. As a result, his investors began to panic, which produced calls for large withdrawals on a scale that Madoff had never previously experienced. . Eventually, the amounts of such withdrawal requests began to far exceed the sums he was able to garner from new clients; thereby, it became impossible to pay long-standing investors when they requested their money.

Recognizing that withdrawal requests were essentially overwhelming his remaining available funds, Madoff had no choice but to turn himself into the authorities. Ironically, since the early 1990s, the SEC and other regulatory agencies had conducted numerous investigations into his operations. However, Harry Markopolos has stated that the SEC employed incompetent investigators who actually did little investigation and/or hired persons who lacked the finance background that would have been required to adequately examine Madoff's operations. For this reason, a number of Madoff's investors have brought suits against the SEC, alleging negligence in failing to detect the fraud that he was committing.

Based on tips from countless investors and financial analysts, a multitude of investment professionals were convinced that Madoff's hyper-consistent returns were far above any reasonable standard; they thus argued that his entire operation was fraudulent. They were eventually proven to be correct.

What Are the Leading Claim Allegations against Corporate Directors and Officers?

As would be expected, numerous class action lawsuits have already been filed against his organization, Bernard L. Madoff Investment Securities LLC, including the firm's directors and officers.

Feeder Funds: Madoff's Conduit to Major Capital

What is now emerging as a key source of claims associated with the scheme are those being filed against so-called "feeder funds." Significantly, one reason Madoff was able to amass such a high dollar volume of funds was due, in part, to the fact investors were referred to him by financial institutions. In additional cases, these entities, who were in the business of managing money for others, simply sent Madoff their investors' money—in return for a commission or fee.

Who Were the Feeders?

Among the types of financial institutions that sent money to Madoff 's company, were commercial banks, investment banks, hedge funds, pension funds, mutual funds, and investment advisors. In fact, one of the key "portals" to the substantial volume of foreign investors' funds through which Madoff gained access was through these so-called feeder funds.

Barely 2 months after revelations about Madoff's scheme became public, by early February 2009, 12 class action lawsuits had been filed against these entities, and of course, against their directors and officers, as well. The suits allege that in referring such persons to and/or investing their money with Madoff, they failed to adequately assess and evaluate the true nature of his operations, and that as a result of such failures, these investors lost huge sums of money.

Claims from Private Equity Operations

Claims involving private equity operations involve lawsuits alleging damage to existing shareholders when public corporations are bought out by what are known as "private equity" groups.

What is a Private Equity Group?

Private equity groups raise 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 use these monies to make various types of investments. Private equity groups acquire companies by buying all of the shares of a company listed on a public stock exchange (such as the

New York Stock Exchange). Having acquired the company in this manner, the private equity firm group 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 at a later date, hopefully for a higher price per share than the one for which it was originally acquired on the public market.

How Do Claims from Private Equity Deals Arise?

As already noted throughout this course, "traditional" merger and acquisition transactions raise the level of D&O claim exposure for a company and its management given the conflicts of interest such transactions create. In contrast, private equity buyouts are fundamentally different from these standard transactions in which one public company buys out another public company. In the latter, management acts as an auctioneer and seeks the highest possible price for their company. But in private equity buyouts, management functions as a buyer, whose aim is to purchase the firm for the lowest possible price. Unlike "traditional" merger and acquisition transactions, in private equity buyouts, management usually remains with and retains a significant equity stake in the new organization that emerges after the private equity buyout is completed. This situation provides the basis of a claim by stockholders who were bought out by the private equity group and its management "partners." Those stockholders then assert that they received an unfairly low per share price when the private equity deal was consummated.

Claims from private equity operations reached their peak in 2007. Given the current recession, such claims have all but disappeared because, like IPOs, private equity buyouts rarely occur. However, such exposures could again increase, once the recession ends and the economy returns to its normal condition.

Chapter 9 Review Questions

1. Lawsuits against the investment banking firms that promoted auction rate securities (ARSs) were based on allegations that:

    a. ARSs went into default when their markets dried up.

    b. Dutch Auctions attracted too many bidders, driving rates down.

    c. Instruments marketed as frozen investments were, in reality, highly liquid.

    d. Instruments marketed as short-term investments turned into long-term investments.

2. All the following factors contributed to the subprime mortgage problem that led to mortgage foreclosures, except:

    a. High teaser rates on subprime mortgages.

    b. Home equity loans.

    c. Low down payments on home sales.

    d. Plummeting real estate values.

3. A common type of derivative that pays off an MBS holder (investor) if the MBS defaults is known as:
   a. A credit default swap.
   b. A hedge.
   c. Securitization.
   d. Speculation.
4. Credit default swaps, which ensure that investors will be paid off if an MBS defaults, are sold in the derivatives market, which is:
   a. Regulated by the National Association of Insurance Commissioners.
   b. Regulated by the Securities Exchange Commission (SEC).
   c. Regulated by state insurance commissioners.
   d. Unregulated.
5. Grimm-Riepers, Inc. invested heavily in bonds with an investment-grade rating from major credit rating agencies. Many of these were mortgage-backed securities that became essentially worthless. Grimm-Riepers' suit against the credit rating agencies' directors and officers most likely alleges that the:
   a. Investments were overrated.
   b. Periodic resetting feature of the underlying investments was not explained properly.
   c. Rating agencies engaged in illegal lending practices.
   d. Rating agencies had a duty to work with the investment banking firms that issued the securities to ensure a mutually acceptable rating.
6. Porcine Bank and its shareholders suffered crushing financial losses as a result of its subprime lending activities. Which of the following is least likely to be the plaintiff in a lawsuit against Porcine Bank's directors and officers?
   a. Porcine Bank's stockholders whose stock value dropped.
   b. Noplace Like Home Builders, Inc., which can't sell homes now because customers can no longer get mortgages from Porcine.
   c. Homer Simons, who had his life savings invested with an asset manager that put a lot of its capital into Porcine MDSs.
   d. Millie Watt, who just refinanced her standard mortgage with Porcine to obtain a lower rate.

7. The Denny Krane Fund invested a substantial portion of its investors' money with Madcow Investments. Madcow reported an outstanding return on investment for several years but ultimately turned out to be a Ponzi scheme. Because its Madcow investments were really worthless, Denny Krane had no choice but to write down the value of its own assets. Angry Denny Krane investors are likely to sue Denny Kane's directors and officers alleging that Denny Krane:
   a. Failed adequately to evaluate Madcow before investing.
   b. Had been conducting its own Ponzi scheme.
   c. Should not even have considered investing with Madcow.
   d. Was too broadly diversified.

Answers to Chapter 9 Review Questions

1. d. Due to a lack of bidders, investors were unable to cash out as needed.
2. a. The problem was that low "affordable" teaser rates later reset to an unaffordable level.
3. a. A credit default swap is, in effect, an insurance policy that promises to pay off the investor if the MBS defaults.
4. d. Because the derivatives market is completely unregulated, Warren Buffet refers to derivatives as "weapons of financial mass destruction."
5. a. Any rational analysis would have indicated that MDSs are not investment-grade securities.
6. d. Millie seems to be benefiting from normal "prime" lending activities and has no obvious basis for any complaint against Porcine.
7. a. Suits against entities that invested in Madcow's Ponzi scheme allege that in investing money with Madcow they failed to adequately assess and evaluate the true nature of his operations, resulting in huge losses.

Chapter 10
Parallel Proceedings

As noted at length, the size of settlements in securities class action claims against directors and officers has increased dramatically in recent years. 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 and therefore parallel to securities class action lawsuits. This chapter sets forth an overview of the four types of "parallel proceedings": (1) derivative claims, (2) opt-out lawsuits, (3) ERISA stock drop claims, and (4) 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 of individual stockholders. 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 therefore paid to the corporation, rather than to the shareholder(s) who institute the action.

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 10.1.

Exhibit 10.1 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 frequency of that practice continues to increase. Increasingly, securities class action lawsuits are being handled (and effectively controlled) by a small group of sophisticated and highly experienced plaintiff law firms. 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.

A Notable Derivative Claim

In recent years, one of the most notable and well-publicized derivative suits was a claim brought against the Walt Disney Company. The suit alleged that Michael Ovitz, who was hired to serve as the company's president, by Disney's then-CEO Michael Eisner, received excessive pay. Specifically, Mr. Ovitz received more than $140 million in compensation and severance, after a "falling-out" with Mr. Eisner—despite having worked at Disney for only 16 months. Shareholders alleged that the directors and officers were negligent in agreeing to an employment contract that provided such rich compensation, despite such a short tenure with the organization. The shareholders alleged that the excessive payment damaged the corporation.

The Court's Findings

Ultimately, the Delaware Chancery Court found in favor of the company's directors and officers. The court ruled that while Mr. Ovitz's compensation package was indeed excessive, the directors and officers were not grossly negligent in agreeing to it. The court cited the business judgment rule (discussed in Chapter 6 of this course), as the means by which Disney's directors and officers could justify hiring Mr. Ovitz, albeit at an exorbitant cost. The court concluded that the directors and officers considered Mr. Ovitz's services so valuable as to justify the high price of his employment contract. While the outcome of the decision was disastrous, because the process by which the decision was arrived at was appropriate, the court did not hold the directors and officers liable.

Opt-Out Lawsuits

In addition to the derivative lawsuit, 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 the 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 may 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 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/officers to conserve policy limits available under their 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 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" obtains 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 and before claim settlements have even been made. Therefore, opt-out plaintiffs often benefit by settling on an accelerated basis, before D&O insurance proceeds have been exhausted by defense costs required during extended litigation.

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 (ERISA), what are termed "ERISA stock drop" (or less commonly referred to as "ERISA tag-along" suits) have become commonplace in recent years.

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

A high percentage of many corporations' 401(k) plans include within such plans' investment choices the option to purchase company stock. 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, often 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.

Concentration of Employer Stock in 401(k) Plans

Studies have indicated that, 7 years after the Enron collapse, company stock is still the single largest employee holding in 401(k) plans. More specifically, studies have shown that approximately 20 percent of all 401(k) monies are invested in company stock. In addition, the study revealed that one in five plan participants have at least half their retirement money invested in company shares.

Why Concentration of Employer Stock in 401(k)'s Remains High

Companies that promote the ownership of company stock in 401(k) plans believe that encouraging employees to own stock creates an "ownership culture" in which employees will be even more committed to the firm's success. Such companies often match employee contributions on a dollar-for-dollar basis when these monies are used to buy company stock. This compares to the typical 401(k) plan that matches only 50 percent of an employee's contributions and only up to 6 percent of the amount contributed. Programs of this nature encourage heavy investment in company stock by 401(k) plan participants.

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. Employee-plaintiffs typically assert that directors and officers:

- 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 failing to adequately monitor wrongdoing by other plan fiduciaries.

Although normally smaller than the settlement amount agreed to in the related securities litigation, settlements in ERISA stock drop litigation have nevertheless been substantial.

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 non-employee 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

In recent years, claims by the SEC, the Department of Justice (DOJ), and other regulators have increased significantly. Since 2001, the SEC budget has more than doubled, and the size of its staff has increased by about 30 percent. Similarly, the number of enforcement proceedings brought by the SEC has increased dramatically in the last several years. Other regulators have likewise become much more active in bringing civil proceedings against companies and their directors and officers. 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 chapter). 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 United Healthcare 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. For example, 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. (The latter 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/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'/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/officer defendants must often engage in duplicate and overlapping discovery activities (i.e., taking the time to provide depositions to both 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 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/officers who were merely negligent) and "black hats" (directors/officers who were also guilty of criminal conduct), is especially problematic in securities class action claims that also involve parallel proceedings. In the Enron case, for example, where a number of officers were convicted of criminal conduct, 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 10 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. 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 directors and officers (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.
3. Last Chance Company employees hold 100,000 shares of Last Chance stock within their 401k plans. When a financial restatement is announced, Last Chance 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 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.

Answers to Chapter 10 Review Questions

1. a. Law firms that are excluded from a class action lawsuit often file a derivate suit in an attempt to obtain a fee award when the class action case settles.
2. b. Opt-out claims handled on an accelerated basis can recover D&O proceeds before the policy's aggregate limit is completely eroded.
3. a. $50 – $30 = $20 per share loss x 100,000 shares = $2 million loss.

Chapter 11
Underwriting Directors & Officers Liability Insurance: Part 1

This chapter begins with a discussion of the data sources used by underwriters to evaluate and price a 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 12 examines the next two factors—(3) internal company issues and (4) composition/operation of the board of directors—that D&O underwriters also evaluate when pricing a D&O risk.

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, there are a number of other items, which are listed in Exhibit 11.1, that organizations must usually provide during the process of being evaluated for directors and officers liability coverage.

Exhibit 11.1 Items Submitted with a D&O Application
• Copies of the corporation's latest annual report • Copies of all proxy material • Corporate bylaws • A list of directors and officers (including subsidiary organizations), with biographical information • The firm's most recent Dun and Bradstreet report • Copies of the most recent financial information filed with the SEC (normally 10K and 10Q reports)

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 explain 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 a(n): (1) auditor's report on the firm's financial statements, (2) balance sheet, (3) statement of retained earnings, (4) income statement, (5) 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 non-audit 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, the 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.

Dun and Bradstreet Report

Dun and Bradstreet is a company that provides credit information on businesses and corporations. Their reports, referred to as "D&B's," use a patented Data Universal Numbering System (DUNS). This unique approach compares and contrasts the financial data of a specific company to those in similar industries. In addition to D&O underwriters, the DUNS system is utilized by every major bank, lender, finance company, and federal agency in evaluating the financial condition and creditworthiness of virtually all businesses.

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—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.

The key financial areas include a firm's:

- 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 Enron was "profitable" right up to the moment it declared bankruptcy.

Profit: An Illusive Concept

In recent years, "profit" has 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 that have not yet been sold). 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, *New York Times* op-ed piece, 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 onetime 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 it was acquired by Bank of America 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 Ken 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 ten examples noted in Exhibit 11.2 are the kinds of accounting and financial reporting practices that are especially problematic

Exhibit 11.2
10 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).
- Overly optimistic news releases or shareholder communications, with the chief executive officer acting as "evangelist" to convince investors of future potential growth (e.g., ex-Enron CEO Kenneth Lay assuring employee 401K holders that the stock has "never been a better buy" only a few months before the firm filed for bankruptcy protection, and after he had sold massive amounts of his personal holdings of Enron shares).
- 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 Mortgage 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; for example, results are always exactly on budget or managers who always achieve 100 percent of bonus opportunities (yet another sign that earnings are being "managed").
- Frequent instances of differences of opinion regarding the accounting treatment of various items, between management and external auditors.
- A pattern of shipping most of the month's or quarter's sales on the last day of the month or on the last day of the quarter.
- Unusual balance sheet changes or abnormal changes in trends of important financial statement relationships (e.g., receivables growing faster than revenues or accounts payable that keep getting delayed).
- Atypical accounting policies, particularly for revenue recognition and cost deferrals (e.g., recognizing revenues before products have even been shipped, a practice known as "bill and hold").

Liquidity

Adequate liquidity (i.e., liquid 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 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.

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.

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 buy-outs, 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 whose products are purchased largely by other businesses—rather than by consumers—are much more vulnerable to wide swings in earnings and, ultimately, claims against its directors and officers. Many of the bankruptcies and financial difficulties experienced by high-tech firms from 2000 to 2002 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 share prices of consumer products manufacturers such as Kraft, Proctor & Gamble, and Johnson & Johnson, were not as severely impacted by the 2007–09 stock market plunge, as were heavy equipment manufacturers that sell almost exclusively to other businesses, like Caterpillar and Deere & Company.

Industry Group

The industry group in which a company operates correlates significantly with D&O claim activity. During the past decade, the pattern that has emerged is one in which a particular industry group bears the brunt of numerous claims, 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 2007-2008 and in 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.

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 11 Review Questions

1. In applying for directors and officers (D&O) 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. Dun and Bradstreet report on Firetower.
   d. Firetower's annual report.
2. In reviewing the roster of directors and officers of Tony's Debt Collection Agency, Inc., a D&O underwriter is least likely to consider the directors' and officers':
   a. Ethnicity.
   b. Experience.
   c. Integrity.
   d. Knowledge.
3. From a 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 over 70 years old.
4. In reviewing of Furniture Factory's (FF) financial records, a D&O underwriter notices that furniture shipments and billings peak rather significantly during the last few days of each quarter. Returns, however, tend to peak early in the quarter. The underwriter is rightfully concerned that this suggests:
   a. FF bookkeepers are lax in recording sales as they are made.
   b. FF has a 3-month manufacturing cycle.
   c. FF is struggling—or fudging—to "make the numbers" in its quarterly sales reports.
   d. FF uses outdated accounting practices.

Answers to Chapter 11 Review Questions

1. b. A complete list of directors and officers, along with biographical information, is usually sufficient.
2. a. The essence of any 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.
3. a. A firm's ability to generate acceptable levels of profits for its investors is the single most important financial indicator evaluated by underwriters.
4. c. FF may be desperately reporting sales figures higher than actual sales.

Chapter 12
Underwriting Directors & Officers Liability Insurance: Part 2

This chapter will examine the other two broad areas considered by D&O underwriters: internal company factors and composition/operation of the 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. M&A 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, a company with a proclivity for M&A activity is usually perceived by underwriters as a higher-than-average claim risk.

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 all of a company's shares are owned by directors/officers/other insiders 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 bringing suits 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.)

Future, Company-Specific Risks

A key risk underwriting factor for any individual company is whether or not the firm is susceptible to a single event or change that could substantially alter the company's fortunes. Examples of such vulnerabilities (but certainly not exhaustive of the going-forward vulnerabilities faced by companies) 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); or (4) a company awaiting the outcome of pending, high-stakes litigation.

Public Offerings and Repurchases

Companies that frequently either (1) repurchase shares of their own stock or (2) sell additional shares of stock to the public are sometimes perceived unfavorably by underwriters.

With respect to repurchases, equity holders often object to the fact that the corporation should have been able to find uses for the firm's capital that were potentially more productive than repurchasing its own stock.

As respects public sales of additional shares in the company, such stock offerings occasionally trigger lawsuits from stockholders who are unhappy about the dilution of their equity that results from these offerings.

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 (5) 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 than for older, more established companies. 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 IPOs) 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 America's Most Admired Companies). Those held in lesser esteem are somewhat more vulnerable to D&O claims than companies that are highly regarded.

Risk Management Program

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, the likelihood of future claim activity is influenced by a firm’s previous loss experience. Nevertheless, that record must be analyzed in light of changes within management and the board of directors. Negative loss experience is no longer meaningful if there has since been a complete turnover within these groups.

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

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.(Groupthink has been defined as "a type of thought exhibited by group members who attempt to mitigate conflict and reach consensus without critically testing, analyzing or evaluating ideas."

Conversely, and although this is less often the case, problems can also arise when the board chairman is relatively weak. Board chairmen who are too easily influenced by others are sometimes coerced into making unwise decisions. Similarly, firms having chairmen with good ideas—but little influence—are also 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 clear 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, 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

There are three specific factors underwriters consider 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 that 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, comprises 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.

Independence

Underwriters must carefully examine the relationships between board members and the companies they have been asked to serve. Accordingly, 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, rather than outside 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

The manner in which operating management is compensated should also be carefully considered by underwriters. 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 in the last several years 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 "Non-Salary" Items

Underwriters should be especially wary of firms in which compensation of management is heavily dependent on non-salary 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 in boosting reported earnings. Another problem is that these non-salary 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 when a CEO's compensation package is heavily impacted by 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.

This was the conclusion of a study by Lin Peng and Alisa Roell 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 highly lucrative consulting engagements which, 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 they 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 meetings 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.

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. 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.

Such meetings have become especially important considering the current environment. Since restatements, as well as auditor complicity in fraud have become commonplace, underwriter meetings with an insured's CFO can help an underwriter develop a "comfort level" with a prospective insured's financial data. Or, 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.

Chapter 12 Review Questions

1. National Acquirer Company's market share is on the rise, since it has gradually been buying out its major competitors. 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 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 bring a suit 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 12 Review Questions

1. c. Acquiring companies are always vulnerable to criticism that the purchase price paid for a company it acquired was excessive.
2. a. One person or organization with a great deal at stake is a prime candidate for bringing suit at the first sign of a business downturn.
3. b. The larger the firm, the more vulnerable it is to suits. Underwriters also prefer older, more-established organizations over relatively new firms.
4. a. Frank's dominance likely creates a groupthink mentality in which his proposals are not carefully examined by other board members.
5. c. As outsiders who also deal with other organizations, these individuals are likely to have a broader, more objective perspective than corporate insiders.

Chapter 13
Controlling Directors & Officers Liability Claims Part 1: General Suggestions

Chapter 13 provides a number of general suggestions on how to prevent D&O claims. Insured companies can implement these suggestions themselves and, in addition, underwriters can recommend that insureds apply such loss control practices. Chapter 14 offers various loss control techniques that apply to the area of corporate governance.

Exhibit 13.1 lists these general techniques, which are discussed in the pages that follow.

Exhibit 13.1 D&O Loss Control Techniques
• Encourage active questioning and appropriate dissent • Rely on legal counsel and outside experts where needed • Insist on a sufficient flow of information from operating managers • Avoid embarrassing corporate actions • Have directors/officers read the firm's D&O policy and application • Monitor insider trading • Investigate warning signs • Don't 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 discussion and the airing of alternative courses of action and viewpoints. The board chairman must encourage dissent among board members and encourage board members to put forth out-of-the-ordinary viewpoints. By discouraging a "yes man" culture within corporate boardrooms, the kinds of wrongdoing witnessed at Countrywide, Enron, Tyco, WorldCom, and others would have been more difficult to carry out.

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

Unfortunately, directorships are almost always 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 questioning his/her ideas and initiatives. Clearly, since the typical member of a board of directors is chosen on the basis of friendship, rather than expertise, the airing of differing viewpoints tends to be the exception, rather than the rule. So to the extent possible, boards should guard against the dangers inherent in “groupthink” based upon personal affinity, relying instead upon true expertise and objectivity.

Consult with Legal Counsel and Outside Experts

In situations where actions must be taken (e.g., responding to a take-over 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 buy-out 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. Even asking questions of regular employees and mid-level management is appropriate.

Avoid Embarrassing Corporate Actions

Management experts frequently advise businesses “never do anything in private that would be embarrassing if revealed to the public.” During the fall of 2008, it was revealed that AIG had spent nearly a half-million dollars to send a number of its sales executives to a junket 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 which encouraged investors to file additional 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 junket.

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/officers should study the documents attached to the application. This is because inaccuracies or outright misrepresentations in such documents have increasingly been used as the basis of rescission (i.e., an action that voids the entire policy) by insurers.

Second, board members should review the claim warranty statement, in which the signer of the application is asked to assert that he/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

The most dangerous component of a serious securities class action lawsuit is the presence of significant insider trading at suspicious time and in suspicious amounts. For example, Enron Chief Operating Officer 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 Mozillo, 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, these policies should be overseen by an effective compliance officer who strictly enforces such rules.

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.

For example, a number of claims involve (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 in which the structure, purpose, terms, and effect of the transactions were not understood by some senior managers and the directors.

Enron: A Case Study in Financial Manipulation

A high percentage of Enron's revenues were generated by "sales" of assets to non-consolidated "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.

Don't 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 unduly emphasizes short-term performance and 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 13 Review Questions

1. Only-a-Dollar Stores, Inc. approaches the board of Dime Stores, Inc. with an offer to buy the company. Whether accepted or rejected, a take-over 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 buy-out offer.
   d. Reject the offer without further negotiation if the price seems too low.
2. Why is it important for board members to review the claim warranty statement in an application for D&O insurance?
   a. Directors should be aware of any exclusions in the warranty.
   b. Directors should know how long the warranty is good for.
   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.

Answers to Chapter 13 Review Questions

1. b. An independent investment firm can provide objective input on the firm's value.
2. c. The person(s) signing the application assert 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.

Chapter 14 Controlling Directors & Officers Liability Claims Part 2: Effective Corporate Governance

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

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, 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.

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 better able to defend themselves if a claim does arise. Exhibit 14.1 lists these "best practices," which are discussed in this chapter.

Exhibit 14.1 “Best Practices” Corporate Governance
• Assure independent decision-making on the board • Require a minimum level of stock ownership • Reform option-related compensation practices • Separate the roles of 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. For example, if a board consists of ten members, only three of whom are insiders, the seven outside directors will constitute an automatic majority.

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 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 were 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 $250,000 equity stake, 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 an equity stake of $250,000. (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.

Accounting Rules Incentivize Option Grant Abuses

Under current accounting rules, stock option grants are not treated as an expense on a corporation's income statement. This rule has 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, supplies corporate executives with incentive—perhaps too much incentive—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 D&O litigation, can produce questionable, if not fraudulent, accounting practices.

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 that have been suggested to change the system of option accounting and granting, include the following.

- 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.
- Charging the cost of option grants against current income (noted above).

- Awarding to executives stock 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 Enron bankruptcy in December 2001 and the other high-profile corporate failures that have followed, one area of corporate governance that has received particular attention is the question of whether the roles of chairman of the board and chief executive officer 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 Common in Canada and the U.K.

Although approximately 80 percent of all American CEOs also serve as board chairmen, the situation is the reverse in Canada and England, where only 20 percent of all CEOs also hold the position of board chairman. A switch to this system would represent a sea change in American corporate governance. Nevertheless, given current investor skepticism and heightened demands for added scrutiny of corporate actions, an argument could be made for improved corporate governance if CEOs were to relinquish their title of "board chairman." In the wake of recent events, a splitting of the CEO and board chairman's roles might also 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 a board must monitor a CEO's performance and hold him accountable for results—if the CEO is also chairman of the board. Indeed, the theoretical roles of chairman of the board and the 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, yet also 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

Fewer than half of all corporate boards hold meetings without the CEO being present. However, 908 directors of Fortune 1000 companies were in favor of holding CEO-free meetings, according to a survey conducted by Korn/Ferry International. Yet since a majority of public corporations do not conduct board meetings without the presence of the CEO, this apparent "disconnect" between survey results and actual practice, indicates that either directors are not insisting on such meetings or CEOs are not allowing them.

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

Among the most important areas in which performance should be evaluated, include:

- regularity of attendance at both board and committee meetings,
- general level of preparedness,
- capacity for asking challenging questions,
- ability to offer creative suggestions, and
- 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 feelings will sometimes be hurt by this process, 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. Among its most important 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 (GAAP) have been followed.

- **Separate Auditing and Consulting Services.** In recent years, virtually all of the major accounting firms have begun offering non-accounting/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. (Note: following the Enron fiasco, Andersen's consulting division split off to form a new, separate company: Accenture. This was partly in recognition of the conflicts that arise when auditing firms also perform consulting work for the same company.)
- **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. One of the most frequent complaints 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 200 hours per year are required to serve as a director of a major corporation. Accordingly, the National Association of Corporate Directors has stated that people should not sit on more than four boards at the same time. 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 serve as officers of such firms. Often, the demands that have been placed on a director from such activities 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.

Semi-Retired 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 “semi-retired.” For example, Avon states that if a board member is a full-time employee of another company, he or she can only sit on no more than two additional boards besides Avon. If not employed full-time, he or she can sit on no more than four additional boards.

Limiting Board Service Is a Growing Trend

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

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, which 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 must be 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 who 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 NYU 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 14.2 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 14.2
American Airlines: A Case Study in Board Interlock

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 14 Review Questions

1. 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.
2. 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 14 Review Questions

1. c. Outside directors have less personal stake in the outcome of these committees' actions.
2. a. Audit committee members should be able to fully understand and critique the company's financial statements.