

# PROFESSIONAL LIABILITY LITIGATION

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## CLASS CERTIFICATION AS A “SIGNAL EVENT” IN FEDERAL SECURITIES CLASS ACTIONS: THE IMPACT ON D&O INSURANCE

*By David H. Topol and Justin D. Heminger*

### Introduction

D&O insurers and defense counsel in the securities bar have long recognized the value of the motion to dismiss in federal securities class actions. A successful motion to dismiss usually ends the litigation before discovery commences and before defendants incur substantial litigation costs. Conversely, where the court denies the motion to dismiss, plaintiffs often argue that defendants will not have another opportunity to achieve a favorable litigated resolution unless and until the court grants a motion for summary judgment. In the meantime, plaintiffs may seek to justify an excessive settlement demand based on the costs of litigation and the risk, even if it is very small, that defendants will not prevail on summary judgment.

In recent years, however, class certification has emerged as another opportunity for defendants to defeat or substantially narrow securities lawsuits. For example, in May of this year, the United States Court of Appeals for the Fifth Circuit held that a district court must evaluate evidence of loss causation at the class certification stage because such evidence goes to class-wide reliance.<sup>1</sup> In so holding, the court stressed the “*in terrorem* power of certification” and the “outdated view that fails to accord this signal event of the case its due.”<sup>2</sup> Similarly, in *In re Initial Public Offering Securities Litigation*,<sup>3</sup> the United States Court of Appeals for the Second Circuit held that at the class certification stage, a district court must consider and resolve factual disputes in determining whether the class certification satisfies the requirements embodied in Rule 23 of the Federal Rules of Civil Procedure.

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## LITIGATION SETTLEMENTS BY INDIVIDUAL OUTSIDE DIRECTORS AND D&O INSURANCE TO PROTECT UNWITTING OUTSIDE DIRECTORS

*By Michael W. Early*

A great deal of attention was garnered by the settlements requiring outside directors to pay from their personal assets in the *Enron* and *WorldCom* securities class action. The recent \$41.5 million settlement by former outside directors in the *Just for Feet* breach of fiduciary duty case again has outside directors wondering if they are putting their personal assets at stake by serving on the boards of public corporations. This recent \$41.5 million settlement is the largest reported settlement payment by individual outside directors. Outside directors of public corporations are left worrying that they may not have adequate protection for their personal assets.<sup>1</sup>

### The *Just for Feet* Settlement

Five former outside directors of *Just for Feet* paid \$41.5 million to settle a bankruptcy trustee’s state court claim against the individual outside directors for breach of fiduciary duty.<sup>2</sup> *Just for Feet* “collapsed amid an accounting fraud” in 1999. In 2000, former *Just for Feet* officers pled guilty to crimes, and the company filed for bankruptcy protection. *Just for Feet* also settled a securities class action lawsuit. After that securities litigation settlement, only \$100,000 remained available from the company’s Director and Officer (“D&O”) insurance. In 2001, the *Just for Feet* bankruptcy trustee filed Alabama state court allegations against the outside directors. The bankruptcy trustee accused the individual outside directors of, among other things, conflicts of interest, misrepresentations, breach of fiduciary duty and bad faith. In September 2006, four former outside directors agreed to pay \$40 million to settle the trustee’s claims against them. In April 2007, the last remaining outside director paid \$1.5 million to settle the trustee’s claims. The former *Just for Feet* outside directors neither admitted nor denied liability.

### Other Outside Director Settlements and D&O Insurance

In the *Enron* and the *WorldCom* securities litigation, the plaintiffs demanded that individual defendants pay out of their

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## Message From the Chairs

### Get Ready For A Big Year

We are very excited to announce that we have improved and expanded our Committee leadership structure for 2007-2008. What's more, we have already filled almost all of the available positions with a terrific group of volunteers. We expect that you will notice positive changes almost immediately in the quality of our newsletter, the appearance and content of our website, and the quality of our programming. Here's what we have done:

- 1) Fully staffed the two Co-Chair positions on each of our five substantive subcommittees (Accountants' Liability, Attorneys' Liability, Attorneys' Loss Prevention and Ethics, Directors' and Officers' Liability, and Professional Liability Insurance Coverage);
- 2) Created and fully staffed two new Subcommittees: Membership and Programming (two Co-Chairs each);
- 3) Fully staffed our existing Newsletter Co-Editor and Website Co-Editor positions;
- 4) Created and fully staffed a Newsletter Editorial Board (six members);
- 5) Created and partially staffed a Website Editorial Board (1 member; 3 open positions);
- 6) Created the Young Lawyer's Council for those under 36 or admitted to practice less than 5 years; and
- 7) Created the Plaintiffs' Perspectives Council to help ensure that we adequately represent that side of the bar.

We are pleased to have such a talented group of volunteers to help the Committee.

We are also pleased to present our Officers and Directors issue of our newsletter, which contains several helpful and interesting articles. We also want to thank our senior newsletter editor, Chad Arnette, who will be stepping down after this issue. Chad has been our senior editor since 2004 and he often produced issues single-handedly. We appreciate all his hard work over the years and wish him well.

If you have any comments or suggestions for our Committee, we want to hear from you!

~Carol

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## CLASS CERTIFICATION AS A “SIGNAL EVENT” ...

(Continued from page 1)

This article addresses recent developments in class certification in the securities class action context and their potential impact on early settlement valuation. Part II explains how courts have imposed increased rigor with respect to both procedural and substantive requirements for class certification. Part III describes how even where the more rigorous standards do not defeat certification, they may operate to narrow the size of the class and thereby reduce potential damages.

### Courts are Making Class Certification Procedurally and Substantively More Rigorous

#### *Heightened Procedural Standards*

The increased procedural rigor in class certification in securities cases has manifested itself in two ways. First, courts have imposed a greater burden on plaintiffs to establish that certification is warranted. Second, courts are requiring an increased evidentiary showing in determining whether to grant certification.

#### **Burden of Proof**

In a 1982 decision, *General Telephone Co. of the Southwest v. Falcon*,<sup>4</sup> the Supreme Court explained that a class action lawsuit “may only be certified if the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied.”<sup>5</sup> Because the Supreme Court did not specify what it meant by “rigorous analysis,” lower courts have struggled to clarify the meaning of the term.

Until recently, many decisions suggested that plaintiffs would not have a heavy burden to meet to persuade a court to certify a class. In *In re Visa Check/MasterMoney Antitrust Litigation*,<sup>6</sup> the Second Circuit held that, in determining whether plaintiffs had met their burden of proof, the “district court must ensure that the basis of the expert opinion [supporting certification] is not so flawed that it would be inadmissible as a matter of law.”<sup>7</sup> Thus, the court concluded: “The question for the district court at the class certification stage is whether plaintiffs’ expert evidence is sufficient to demonstrate common questions of fact warranting certification of the proposed class, not whether the evidence will ultimately be persuasive.”<sup>8</sup> Similarly, the

Third Circuit, in *Chiang v. Veneman*,<sup>9</sup> described the burden of proof at certification as similar to that required for Rule 12(b)(6) motions: “We note that it is not necessary for the plaintiffs to establish the merits of their case at the class certification stage, and that, in determining whether a class will be certified, the substantive allegations of the complaint must be taken as true.”<sup>10</sup>

More recently, though, courts have imposed a greater burden on plaintiffs. The Second Circuit’s *IPO Securities Litigation* decision illustrates this trend. The *IPO Securities Litigation* lawsuit was brought by investors against 55 securities underwriting firms, 310 companies that issued stock in initial public offerings, and hundreds of officers at the issuing companies. The plaintiff investors alleged that the defendants conspired to use various fraudulent schemes to profit from the initial public offerings. At the class certification stage, the district court rejected the defendants’ argument that plaintiffs must support class certification based on a “preponderance of the evidence.” Instead, the court held only that plaintiffs “must make ‘some showing.’” That showing may take the form of, for example, expert opinions, evidence (by document, affidavit, live testimony, or otherwise), or the uncontested allegations of the complaint.<sup>11</sup>

The Second Circuit reversed. It expressly “disavowed” the suggestion that “some showing” could suffice to support class certification. Instead, the court held that the district court must find that “whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met.”<sup>12</sup>

Other federal circuits also have tightened the burden of proof at the class certification stage.<sup>13</sup> The Seventh Circuit, in *Szabo v. Bridgeport Machines, Inc.*,<sup>14</sup> held that a district court had applied too weak a standard in certifying a national products liability class action. The district court had declared its reliance on “the principle that, in ruling on a class certification, the question is ‘whether plaintiff is asserting a claim which, assuming its merit, will satisfy the requirements of Rule 23.’”<sup>15</sup> The district court therefore had refused to allow the defendant-manufacturer to challenge the plaintiff’s theory that local dealers of the defendant’s product were agents of the defendant. The Seventh Circuit vacated and remanded, holding that “[a] court may certify a class under Rule 23(b)(3) only if it finds that all of the prerequisites (such as numerosity) have been demonstrated.”<sup>16</sup> In

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## CLASS CERTIFICATION AS A “SIGNAL EVENT” ...

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rejecting the district court’s conclusion that it had to accept the complaint’s allegations as true for purposes of certification, the Seventh Circuit stated that this position “cannot be found in Rule 23 and has nothing to recommend it.”

### Evidentiary Requirements

Recent class certification decisions by the federal circuits also have made clear that district courts must engage in factual findings at the class certification stage. In *Gariety v. Grant Thornton, LLP*,<sup>18</sup> for example, the Fourth Circuit held that a district court failed to engage in “rigorous” analysis when it granted certification based solely on the plaintiff’s allegations.

In *IPO Securities Litigation*, the Second Circuit explained that “the district judge must receive enough evidence, by affidavits, documents, or testimony, to be satisfied that each Rule 23 requirement has been met.”<sup>19</sup> Although the court noted some of these evidentiary issues could overlap with merits issues, it held that the district court

“[C]lass certification has emerged as another opportunity for defendants to defeat or substantially narrow securities lawsuits.”

must consider evidence at this early stage. However, to avoid “a protracted mini-trial of substantial portions of the underlying litigation,” the Second Circuit held that “a district judge must be accorded considerable discretion to limit both discovery and the extent of the hearing on Rule 23 requirements.”<sup>20</sup>

The Third Circuit has explained that a district court can no longer take plaintiffs’ allegations at face value, but must scrutinize the factual record to determine whether plaintiffs have met the Rule 23 requirements.<sup>21</sup> Thus, in a case where the affidavits and depositions of selected plaintiffs belied allegations of uniform misrepresentations to the class members, the district court did not abuse its discretion in denying certification.<sup>22</sup>

The First Circuit has described the evidentiary requirements as a balancing test in which the district court evaluates class counsel’s evidence “critically” while preventing the defendant from conducting “an *unwieldy* trial on the merits.”<sup>23</sup> Thus, a district court has broad discretion to hear and assess evidence at the class certification stage. When the First Circuit remanded the *In re PolyMedica* action for reconsideration on the class certification issue, the district court took the First Circuit’s guidance to heart.<sup>24</sup> On remand, the district court evaluated two affidavits and testimony from plaintiffs’ expert and accepted testimony and evidence from the defendant. The court then conducted an extensive technical analysis involving “information effi-

ciency” and “fundamental value efficiency.” After this lengthy analysis, the court denied class certification because the defendant had effectively rebutted the lead plaintiff’s “weak showing” of market efficiency.<sup>25</sup>

The Fifth Circuit’s recent decision in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*<sup>26</sup> exemplifies how this increased rigor may require securities plaintiffs to produce finely-tuned expert testimony to survive class certification. In *Oscar*, the Fifth Circuit held that the district court abused its discretion in certifying a securities class action where “[t]he plaintiff’s expert report did not establish loss causation.”<sup>27</sup> The Fifth Circuit noted that the district court had balanced all of the evidence presented in concluding that “it is more likely than not that a significant part of the stock decline causing the putative Class’s loss is attributable to the . . . corrective disclosure.”<sup>28</sup> The Fifth Circuit observed that much of the plaintiff’s evidence consisted of analyst reports attributing the stock drops to the company’s financial restatement, but the court characterized these materials as “little more than well-informed speculation.”<sup>29</sup> The court also found plaintiff’s expert testimony unsatisfactory. Although plaintiff’s expert had provided event studies, the court noted that the event studies only indicated that the market for the company’s stock was efficient because it responded to multiple negative events. The court explained that the expert needed to provide some analysis to demonstrate that “the corrective disclosure was more than just present at the scene,” for example, a “supporting study of the market at issue – such as now common use of basic principles of econometrics.”<sup>30</sup> Although the court did not insist upon event studies, it made clear that a plaintiff cannot simply rely on analyst opinions.

The contours of how much discovery is permitted and how much evidence is required at the class certification stage remain imprecise because those issues are, in part, within the discretion of the district court. But recent decisions signal that a district court must consider more evidence than previous practice required. Thus, in a case where strong arguments exist regarding issues such as market efficiency or loss causation, class certification may offer defendants a ripe opportunity to defeat a case before full-blown merits discovery commences.

### Heightened Substantive Standards

In a securities class action, plaintiffs must satisfy six requirements before the court will certify the class – the Rule 23(a) prerequisites of numerosity, commonality, typicality, and adequacy of representation; and, the Rule 23(b)(3) requirements of predominance and superiority.<sup>31</sup> Just as the federal circuits have heightened the procedural standards for certification, federal district courts also now scrutinize a number of these “substantive” requirements more carefully.

#### Predominance

Under the first part of Rule 23(b)(3), the district court must find that “the questions of law or fact common to the members of the class predominate over any questions affecting only individual members.”<sup>32</sup> The Rule 23(b)(3) predominance requirement may provide a particu-

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larly fruitful opportunity to defeat class certification.

In particular, in private securities fraud cases under Section 10 (b) of the Securities Exchange Act of 1934, the issue of reliance offers defendants a good avenue for challenging class certification in some cases. To establish classwide reliance, plaintiffs generally argue that the fraud-on-the-market doctrine applies and creates a rebuttable presumption that the entire class relied upon the defendant's alleged misrepresentations.<sup>33</sup> The doctrine holds that, if a stock is traded on an efficient market, its price responds to all material, available information, thus reflecting the stock's actual value; and, plaintiffs are presumed to rely on this efficiency when purchasing and selling shares. To satisfy the presumption, therefore, plaintiffs must prove the stock was traded on an efficient market.

In recent years, a number of federal courts have denied class certification motions for securities class actions after concluding that plaintiffs did not prove or could not rely upon the classwide fraud-on-the-market presumption of reliance.<sup>34</sup> Recently, the Fifth Circuit in *Oscar* held that "loss causation is a fraud-on-the-market prerequisite," which had to be "established at the class certification stage by a preponderance of all admissible evidence."<sup>35</sup> As noted in Part II.A.2 above, plaintiffs had even proffered expert evidence on this issue, but the court found it insufficiently rigorous.

Other courts have denied or reversed certification because plaintiffs failed to prove an efficient market.<sup>36</sup> For instance, the *IPO Securities Litigation* court held that the market for IPO shares was inefficient as a matter of law.<sup>37</sup> According to the court, without a well-balanced market, the price of IPO shares does not adjust based on material information. The court pointed to the 25-day "quiet period" during which securities analysts are barred from discussing the IPO as just one factor contributing to the IPO market's inefficiencies. Even plaintiffs conceded that, after knowledge of the fraudulent scheme became widely disseminated, the IPO market was still slow to adjust.

A Fifth Circuit opinion flowing from the Enron collapse, *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,<sup>38</sup> demonstrates that defendants can challenge even the existence of a material misrepresentation at the class certification stage. In that case, the putative class of Enron stockholders attempted to hold a number of banks liable for their stock losses from Enron's collapse. Plaintiffs alleged that the banks had participated in a fraudulent scheme with Enron to artificially boost Enron's revenues, thereby inflating Enron's stock.

In denying class certification, the Fifth Circuit held that plaintiffs had not established that "the defendant made public and material misrepresentations; i.e., the type of fraud on which an efficient market may be presumed to rely."<sup>39</sup> The court also ruled the banks did not owe duties of public disclosure to Enron's shareholders, so that even if the banks made material misrepresentations, plaintiffs were not entitled to rely on them. Furthermore, according to the court, the banks' conduct as a matter of law did not constitute manipulative devices to which efficient markets would presumptively respond.<sup>40</sup>

*Credit Suisse* illustrates that class certification presents an important additional opportunity to reduce considerably the exposure in a securities case. Although the district court denied defendants' motion to dismiss and granted plaintiffs' certification motion, defendants were able to use a Rule 23(f) appeal to prevail. By accepting the appeal, the Fifth Circuit recognized that "[t]he necessity of establishing a classwide presumption of reliance in securities class actions makes substantial merits review on a Rule 23(f) appeal inevitable."

### Superiority

The second part of Rule 23(b)(3) requires the district court to find that "a class action is superior to other available methods for the fair and efficient adjudication of the controversy."<sup>42</sup> On some occasions, courts have denied class certification where plaintiffs failed to prove superiority.

The Fourth Circuit found that a class action was not the superior method of adjudication in *Gregory v. Finova Capital Corp.*<sup>43</sup> In *Finova*, a company issued allegedly worthless notes to shareholders to allow it to pay off debt to its principal lender. The company went into bankruptcy, and its shareholders sued both the company and its principal lender in a class action alleging violations of Sections 11 and 15 of the Securities Act of 1933. After the class action was filed, the company's unsecured creditors brought an adversary proceeding against the principal lender that alleged the same violations of securities laws asserted in the class action. The district judge then certified the class, and the principal lender appealed.

The Fourth Circuit reversed the certification. The court first noted that, when the district court performed its superiority analysis, it considered only whether a class action was superior to individual lawsuits. The district court failed to consider whether the class action was a superior method of adjudication when compared to the pending adversary proceeding. In doing so, the district court ignored a factor listed in Rule 23(b)(3)(B): "[T]he extent and nature of any litigation concerning the controversy already commenced by or against members of the class." The Fourth Circuit held that certification was inappropriate because the pending adversary proceeding would be a fair and efficient method of adjudication.

The Third Circuit in *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*<sup>44</sup> affirmed the district court's denial of certification because the individual questions in plaintiffs' claims were too numerous to make a class action a superior method of adjudication. The putative class of investors alleged that the broker-dealer defendants had breached the duty of best execution by not considering potentially cheaper ways to execute the investors' NASDAQ trades. The Third Circuit explained that it would "probe beyond the surface of plaintiffs' allegations in performing our review to assess whether plaintiffs' securities claims satisfy FED. R. CIV. P. 23's requirements."<sup>45</sup>

Although the *Newton* court had doubts about predominance, it eventually pointed to the lack of superiority as fatal to certification. Rule 23(b)(3) required the court to address "the difficulties likely to be encountered in the management of a class action."<sup>46</sup> The court con-

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cluded that those difficulties were insurmountable because the putative class's members numbered in the hundreds of thousands, and the trades involved “hundreds of millions of transactions executed over several years.”<sup>47</sup> The central issue with regard to each plaintiff and each defendant was whether the defendant breached a duty in executing the plaintiff's individual trades because the trades could have been executed at a better price. The defendants were entitled to raise individual defenses, and plaintiffs had to prove actual injury. Both showings had to be determined on an individualized basis. The court concluded that these individualized determinations made class action litigation unmanageable. Additionally, the efficiency and man-

“[D]efendants are most likely to use Rule 23(a)(4) to defeat a class where the class presents unusual circumstances. In an appropriate case, however, it may afford another avenue of attack.”

ageability of certifying the class for trial presented difficulties because there were “simply too many uncommon issues, and the number of class members is surely too large.”<sup>48</sup> The court also noted that certifying the class would put “hydraulic pressure” on defendants to settle, and this was an additional factor weighing against a finding of superiority.<sup>49</sup>

### Adequacy of Representation

Rule 23(a)(4) requires plaintiffs to prove that “the representative parties will fairly and adequately protect the interests of the class.”<sup>50</sup> Adequacy of representation offers defense counsel the opportunity to defeat class certification by challenging the “adequacy” of either the lead plaintiffs or plaintiffs' counsel, or both.

Defendants may challenge whether the lead plaintiffs are able competently to represent the class and whether the named plaintiffs have conflicts of interest with class members under the heightened standards of competence established by the Private Securities Litigation Reform Act of 1995 (“PSLRA”).<sup>51</sup> A recent federal district court decision, *In re Organogenesis Securities Litigation*,<sup>52</sup> illustrates circumstances that may lead to denial of certification for inadequate representation. The court held that plaintiffs had satisfied each Rule 23 requirement except Rule 23(a)(4). With regard to Rule 23(a)(4), the court explained that the Fifth Circuit required that plaintiffs “must show first that the interests of the representative party will not conflict with the interests of any of the class members, and second, that counsel chosen by the representative party is qualified, experienced and able to vigorously conduct the proposed litigation.”<sup>53</sup> Class counsel's performance in the current litigation could also be a factor.

Thus, the test evaluates both lead plaintiffs and class counsel for their ability to represent the class.

The *Organogenesis* court held that Milberg Weiss, the sole class counsel in the case, was inadequate for three reasons. First, the firm had failed to review one of the lead plaintiff's trading records when filing the lead plaintiff's sworn certification of trading activity during the class period, resulting in the submission of a faulty certification. Second, Milberg Weiss and two of its lead partners had recently been indicted for fraud and obstruction of justice due to allegations that the firm bribed lead plaintiffs in class actions. Finally, Milberg Weiss had submitted a letter to the court that asserted that none of the lead partners who were indicted was involved in the case. One of the indicted partners, however, had signed the amended complaint and the lead plaintiffs' engagement letters. Although the partner had left the firm before Milberg Weiss sent the letter to the judge, the court found this “fine shading of words” contributed to a lack of confidence in Milberg Weiss's ability to represent the class.<sup>54</sup> The court therefore refused to certify the proposed class.

As *Organogenesis* suggests, defendants are most likely to use Rule 23(a)(4) to defeat a class where the class presents unusual circumstances. In an appropriate case, however, it may afford another avenue of attack.

### Class Certification Motions May Be a Strategy to Reduce Damages

Even if defendants ultimately are unable to defeat a class at the certification stage, they may still use the class certification motion as a strategy to reduce the potential damages at settlement or trial. Under this approach, defendants must convince the court that plaintiff's proposed class definition is overbroad because it does not satisfy one or more Rule 23 requirements. The court has broad discretion to “limit or modify class definitions to provide the necessary precision;”<sup>55</sup> and, by narrowing the class criteria and/or class period, the court may reduce the potential damages.

#### *Shrink the Damages by Narrowing the Membership Criteria*

Potential damages may be reduced if defense counsel convinces the court that it must narrow the class definition's membership criteria to comply with the Rule 23 requirements. For example, in a case involving allegations that a financial institution made misrepresentations about its investment portfolio management program, a federal district court in Virginia eliminated all claims brought under the Investment Advisers Act<sup>56</sup> after the defendant argued that the lead plaintiff could not adequately represent the putative class as to those claims.<sup>57</sup> To reach this conclusion, the court analyzed the Investment Advisers Act and determined that the only private cause of action it provided was an equitable remedy of rescission and restitution. The lead plaintiff sought rescission of his investment agreement while some members of the class who were still in the investment program did not want rescission. Thus, the lead plaintiff's position was in conflict with other putative class members as to those statutory claims. Since the lead plaintiff could not adequately represent the class as to

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the Investment Advisers Act claims, the court excluded them from the class definition as “not amenable to class treatment.”<sup>58</sup>

Defendants also have convinced some courts to narrow the class definition by excluding all claims brought by foreign class members. At least two district courts have excluded some or all foreign plaintiffs’ claims for failure to meet the Rule 23(b)(3) superiority requirement.<sup>59</sup> The courts reasoned that the foreign shareholders’ countries were unlikely to give a judgment in the class action litigation res judicata effect, posing superiority concerns. Rather than denying certification, one of the two district courts defined the class to exclude foreign plaintiffs who could not prove superiority as to their countries while the other district court chose to “certify a class comprising only domestic investors.”<sup>60</sup>

When a class definition is too broad, the court also has discretion to deny certification and allow plaintiffs to seek a more limited class in a subsequent motion. In denying the *IPO Securities Litigation* plaintiffs’ petition for rehearing, the Second Circuit noted that, after being rebuffed in their first certification motion, plaintiffs were “essentially complaining that we failed to narrow their class definition to an extent that might have satisfied Rule 23 requirements.”<sup>61</sup> The court refused to entertain that idea: “Whatever authority we might have had to undertake that task, we did not think it appropriate to provide legal advice to experienced class action litigators.”<sup>62</sup> The court concluded that the plaintiffs could still “seek certification of a more modest class, one as to which the Rule 23 criteria might be met, according to the standards we have outlined.”<sup>63</sup> Thus, plaintiffs had to redefine the class themselves and file a revised motion for class certification.

#### *Shrink the Damages by Narrowing the Class Period*

Potential damages may also be reduced if the court shrinks the class period when granting a certification motion. In *In re Cornerstone Propane Partners, L.P. Securities Litigation*,<sup>64</sup> for example, a federal district court in California certified a class but restricted the class definition to exclude members who purchased or sold their stock prior to July 2001 because the defendants demonstrated that those putative members could not prove loss causation. The plaintiffs had pled a class period that ran from July 29, 1998 to February 11, 2003. However, the court agreed with defendants that the complaint alleged partial corrective disclosures beginning on July 27, 2001, and the stock price began to fall following those disclosures. Relying on *Dura Pharmaceuticals, Inc. v. Broudo*,<sup>65</sup> the court found that the plaintiffs who had sold their stock before the first corrective disclosure on July 27, 2001 would be unable to prove loss causation because they could not show a causal link between their alleged loss and the defendants’ fraudulent activity. The court therefore certified the class with an amended class definition to exclude all “plaintiffs who purchased and sold their stock prior to any corrective disclosure in July 2001.”<sup>66</sup> Although the defendants did not defeat certification, they at least narrowed the class period.

**“Potential damages may be reduced if defense counsel convinces the court that it must narrow the class definition’s membership criteria to comply with the Rule 23 requirements.”**

Another court shortened the class period after finding that commonality was missing for part of the class period. This decision, first discussed in Part III.B above, involved allegations that a financial institution either failed to disclose or misrepresented material information about its investment portfolio management program. Plaintiffs sought to certify a class of investors who participated in the program at any time between April 26, 1999 “continuing forward” through at least May 9, 2003.<sup>67</sup> However, the court held that commonality only existed in a class defined as “investors between May 17, 2001 and May 2003 who waived trade confirmations.”<sup>68</sup> Plaintiffs outside this limited class period could not prove commonality because, prior to May 17, 2001, the investors did not have the option to waive trade confirmations, each of which contained a full disclosure; and, after May 2003, the defendant included a full disclosure in its marketing materials.

In another case, a federal district court in Illinois agreed with the defendants that the class definition was overbroad because it included individuals who had sold stock during the time plaintiffs alleged that the stock price was artificially inflated.<sup>69</sup> The plaintiffs proposed a class definition that included all individuals who owned the company’s stock, which was converted during a corporate merger on June 12, 1998. But the district court calculated the value of the stock and determined that those plaintiffs who sold their shares prior to August 24, 1999 had made a profit and, thus, had to be excluded as a matter of law from the class definition.

#### **Conclusion**

From the perspective of securities defendants and their insurance carriers, the trend toward a more rigorous analysis of the securities litigation at the class certification stage is a welcome development. Even if plaintiffs can skate by a motion to dismiss by relying on unsubstantiated allegations, class certification may require them to proffer evidence, particularly as to reliance and loss causation, that does not withstand scrutiny.

This trend also suggests that, in cases where there are good grounds to challenge class certification, mediation before a decision on certification may be premature. The common justification for an early settlement following denial of the motion to dismiss is that the next opportunity for a meaningful ruling by the court will be after summary judgment is briefed, which will be many months or years in the future and will occur only after substantial depletion of the available insurance proceeds through advancement of defense costs. If, however, good grounds exist to challenge whether the lawsuit should proceed as a class action, then the court will have an opportunity to limit the scope of the case at a much earlier juncture.

Even if mediation takes place prior to class certification, the issue may be an important one to consider for purposes of settle-

## CLASS CERTIFICATION AS A “SIGNAL EVENT” ...

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ment. Defendants can point out that plaintiffs face a real risk of an early adverse ruling that ends the case before the defendants are forced to complete substantial discovery. Indeed, in some cases, the arguments against class certification may be sufficiently strong to warrant retaining an expert on the class issues for purposes of the mediation.

While the law on these issues is still developing, in recent years it has evolved in a very favorable direction. Defendants and their carriers should use these developments to support earlier efforts to defeat cases and to obtain more favorable settlements in cases where there are reasonable grounds to challenge certification. ð

- 1 *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, No. 05-10791, 2007 WL 1430225, at \*6-7 (5th Cir. May 16, 2007).
- 2 *Id.* at \*4.
- 3 471 F.3d 24 (2d Cir. 2006), *reh'g denied*, 2007 WL 1097892 (2d Cir. Apr. 6, 2007).
- 4 457 U.S. 147 (1982).
- 5 *Id.* at 161.
- 6 280 F.3d 124 (2d Cir. 2001).
- 7 *Id.* at 135.
- 8 *Id.*
- 9 385 F.3d 256 (3d Cir. 2004).
- 10 *Id.* at 262 (citing *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177-78 (1974)).
- 11 *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 30 (2d Cir. 2006) (citation omitted), *reh'g denied*, 2007 WL 1097892 (2d Cir. Apr. 6, 2007).
- 12 *Id.* at 41.
- 13 *See, e.g., Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 168-69 (3d Cir. 2001) (“We must probe beyond the surface of plaintiffs’ allegations in performing our review to assess whether plaintiffs’ securities claims satisfy Fed. R. Civ. P. 23’s requirements.”); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, No. 05-10791, 2007 WL 1430225, at \*5 (5th Cir. May 16, 2007) (“Relatedly, Rule 23’s requirements must be given their full weight *independent* of the merits. District courts often tread too lightly on Rule 23 requirements that overlap with the 10b-5 merits, out of a mistaken belief that merits questions may never be addressed at the class certification stage.”).
- 14 249 F.3d 672 (7th Cir. 2001).
- 15 *Id.* at 675 (citation omitted).
- 16 *Id.* at 676.
- 17 *Id.* at 675.
- 18 368 F.3d 356 (4th Cir. 2004).
- 19 *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 41 (2d Cir. 2006), *reh'g denied*, 2007 WL 1097892 (2d Cir. Apr. 6, 2007).
- 20 *Id.*
- 21 *Johnston v. HBO Film Mgmt., Inc.*, 265 F.3d 178, 186-91 (3d Cir. 2001).
- 22 *Id.* at 186-90.
- 23 *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 17 (1st Cir. 2005).

- 24 *In re PolyMedica Corp. Sec. Litig.*, 453 F. Supp. 2d 260, 266-278 (D. Mass. 2006).
- 25 *Id.* at 278.
- 26 No. 05-10791, 2007 WL 1430225 (5th Cir. May 16, 2007).
- 27 *Id.* at \*7.
- 28 *Id.*
- 29 *Id.* at \*8.
- 30 *Id.* at \*8-9.
- 31 FED. R. CIV. P. 23(a)-(b).
- 32 FED. R. CIV. P. 23(b)(3). The rule is fleshed out with a list of four non-exclusive factors courts should consider: “(A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.” *Id.* Although the circuits do not always explicitly emphasize these factors, at least one circuit panel recently noted the district court’s failure to consider a relevant factor. *See Gregory v. Finova Capital Corp.*, 442 F.3d 188, 191 (4th Cir. 2006).
- 33 *Unger v. Amedisys*, 401 F.3d 316, 322 (5th Cir. 2005). The fraud-on-the-market theory was established by the Supreme Court in the plurality decision in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).
- 34 At least five federal circuits have refused to certify securities class actions because plaintiffs could not prove the classwide presumption of reliance applied. *See In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 17-19 (1st Cir. 2005); *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 42-43 (2d Cir. 2006), *reh'g denied*, 2007 WL 1097892 (2d Cir. April 6, 2007); *Johnston v. HBO Film Mgmt., Inc.*, 265 F.3d 178, 192-94 (3d Cir. 2001); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 172-77 (3d Cir. 2001); *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 362-70 (4th Cir. 2004); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, No. 05-10791, 2007 WL 1430225, at \*4-9 (5th Cir. May 16, 2007); *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, No. 06-20856, 2007 WL 816518, at \*15-16 (5th Cir. March 19, 2007); *Unger v. Amedisys*, 401 F.3d 316, 322-25 (5th Cir. 2005).
- 35 *Oscar*, 2007 WL 1430225, at \*6.
- 36 *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 17-19 (1st Cir. 2005); *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 42-43 (2d Cir. 2006), *reh'g denied*, 2007 WL 1097892 (2d Cir. April 6, 2007); *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 368 (4th Cir. 2004); *Unger v. Amedisys*, 401 F.3d 316, 324-25 (5th Cir. 2005).
- 37 *IPO Sec. Litig.*, 471 F.3d at 42-43.
- 38 No. 06-20856, 2007 WL 816518 (5th Cir. March 19, 2007).
- 39 *Id.* at \*9.
- 40 Judge Dennis concurred in the *Credit Suisse* panel’s result, but disagreed with its reasoning. *Id.* at \*16 (Dennis, J., concurring in the judgment).
- 41 *Credit Suisse*, 2007 WL 816518, at \*15.
- 42 FED. R. CIV. P. 23(b)(3).
- 43 442 F.3d 188 (4th Cir. 2006).
- 44 259 F.3d 154 (3d Cir. 2001).
- 45 *Id.* at 168-69.
- 46 FED. R. CIV. P. 23(b)(3)(D).
- 47 *Newton*, 259 F.3d at 191.
- 48 *Id.* at 192.

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- 49 *Id.*
- 50 FED. R. CIV. P. 23(a)(4).
- 51 *Berger v. Compaq Computer Corp.*, 257 F.3d 475, 482-84 (5th Cir. 2001) (“[T]he PSLRA raises the standard adequacy threshold.”).
- 52 No. 04-10027, 2007 WL 776425 (D. Mass. March 15, 2007).
- 53 *Organogenesis*, 2007 WL 776425, at \*8.
- 54 *Id.* at \*10.
- 55 *In re Monumental Life Ins. Co.*, 365 F.3d 408, 414 (5th Cir. 2004).
- 56 15 U.S.C. § 80b-6.
- 57 *Morris v. Wachovia Sec., Inc.*, 223 F.R.D. 284, 296-99 (E.D. Va. 2004).
- 58 *Id.* at 299.
- 59 *In re Vivendi Universal, S.A. Sec. Litig.*, No. 02 Civ. 5571 (RJH) (HBP), 2007 WL 861147, at \*31-32 (S.D.N.Y. Mar. 22, 2007); *In re DaimlerChrysler AG Sec. Litig.*, 216 F.R.D. 291, 300-01 (D. Del. 2003).
- 60 *DaimlerChrysler*, 216 F.R.D. at 301.
- 61 *In re Initial Pub. Offering Sec. Litig.*, Docket No. 05-3349-cv, 2007 WL 1097892, at \*1 (2d Cir. Apr. 6, 2007).
- 62 *Id.*
- 63 *Id.*
- 64 No. C 03-2522 MHP, 2006 WL 1180267 (N.D. Cal. May 3, 2006).
- 65 544 U.S. 336 (2005).
- 66 *In re CornerStone*, 2006 WL 1180267, at \*9. A federal district court in Virginia has reached the opposite conclusion about *Dura*. *In re BearingPoint, Inc. Sec. Litig.*, 232 F.R.D. 534, 543-44 (E.D. Va. 2006) (“In sum, because in-and-out traders may conceivably prove loss causation, they are appropriately counted as members of the proposed class.”).
- 67 *Morris v. Wachovia Sec., Inc.*, 223 F.R.D. 284, 287-88 (E.D. Va. 2004).
- 68 *Id.* at 293-94.
- 69 *Levitán v. McCoy*, No. 00 C 5096, 2003 WL 1720047, at \*7-8 (N.D. Ill. Mar. 31, 2003).

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## STOP, LOOK, LISTEN . . . AND EXERCISE INDEPENDENT JUDGMENT: COMMON SITUATIONS IN WHICH DIRECTOR FIDUCIARY DUTIES ARISE

*By Mitchell Bryan and Christine S. Bautista*

The perils of acting as a public company director or officer have gone up. Specifically, Sarbanes-Oxley increases directors' and officers' risk in connection with a host of possible claims or violations, either by increasing the odds they will be implicated in such claims or by increasing the resulting penalties.<sup>1</sup>

It is widely recognized that, in recent years, particularly since the enactment of Sarbanes-Oxley, director conduct has come under increasingly greater scrutiny. Current data indicates that the most frequent claims against directors and officers involve breaches of fiduciary duty.<sup>2</sup> Yet it is unclear whether directors are improving their knowledge and understanding of their fiduciary obligations and of how to perform these obligations under frequently encountered circumstances so as to minimize exposure to personal liability. This article provides an overview of director fiduciary duties and applies them to common scenarios that directors may face against the backdrop of recent fiduciary duty rulings in the courts.

### Director Fiduciary Duties

Directors are responsible for supervising or directing the management of the company's business and affairs.<sup>3</sup> Accordingly, they are responsible for overseeing the affairs of the company and exercising judgment concerning important business decisions. These responsibilities stem from the core fiduciary duties of loyalty and care, which common law imposes and state statute may alter.<sup>4</sup>

The duty of loyalty requires a director to protect the interests of

the company and its shareholders, to refrain from engaging in self-interested or conflicted transactions, and to act in a manner that is in the best interest of the company and its shareholders.<sup>5</sup> The director must also act in good faith. The duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom the director is a fiduciary.<sup>6</sup>

The duty of care requires that directors “use that amount of care which ordinarily careful and prudent men would use in similar circumstances” and “consider all material information reasonably available” in making business decisions.<sup>7</sup> The duty of care includes the directors' duty to take affirmative steps to inform themselves before making a business decision, to disclose material information to shareholders, and to inform themselves reasonably of alternatives.<sup>8</sup>

If there is evidence that a director breached the duty of loyalty, then the business judgment rule (discussed below) will not protect his or her decisions.<sup>9</sup> Furthermore, if a director stands on both sides of a transaction (or is otherwise self-interested), then courts apply the entire fairness standard of review to determine whether the director breached the duty of loyalty.<sup>10</sup> Under the entire fairness test, courts review the transaction to determine whether the terms of the transaction (i.e., price) were fair and whether the negotiation process was arm's length. The entire fairness test applies whenever there is a merger between a parent and subsidiary.

### The Business Judgment Rule

While the definitions of duty of loyalty and duty of care appear broad and the applications of these duties may vary under different



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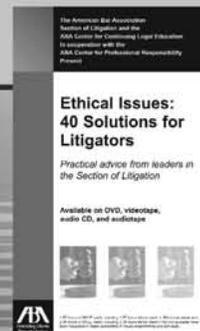
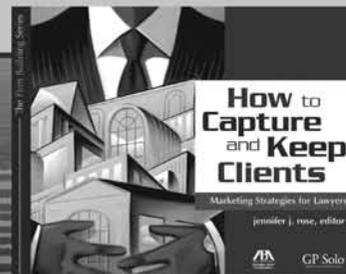
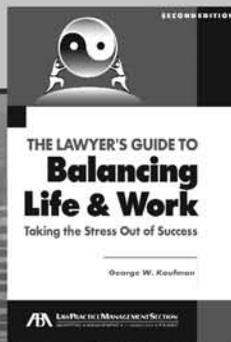
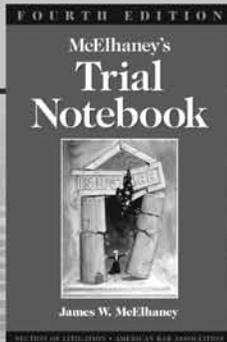
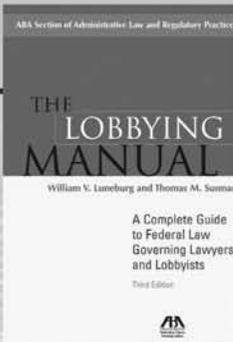
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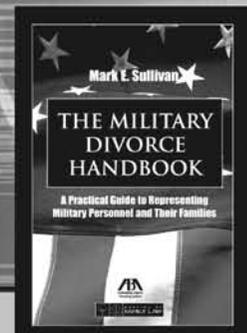
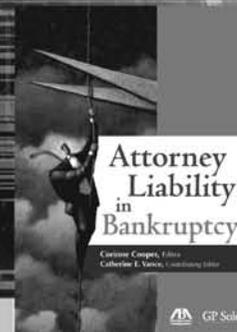
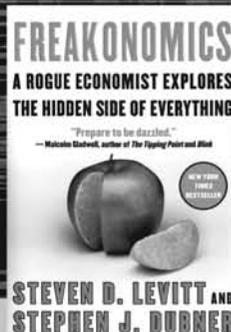
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circumstances, the law typically gives deference to the business judgment of directors, unless self-interest influenced that judgment. Courts' deference is called the business judgment rule.<sup>11</sup> Under this rule, courts must refrain from second-guessing directors' business decisions. Courts, therefore, must presume that the directors acted on an informed basis, in good faith, and in the best interests of the company and shareholders, unless evidence showing the directors failed to act (1) in good faith, (2) in the honest belief that the action was in the best interest of the corporation, or (3) on an informed basis rebuts this presumption.<sup>12</sup>

### Common High-Risk Scenarios

To better understand the previously mentioned concepts, the following hypotheticals and parallel judicial rulings illustrate how fiduciary duty rules apply in certain situations that corporate directors commonly encounter.

#### *Acquisition of Company in Which Director Has an Interest*

Assume you are director of Company A and you are also a director of Company B, which owns 70 percent of Company A's shares. Company B seeks to acquire Company A. Should you be involved in Company B's decision to acquire Company A?

In this hypothetical, as a director of both Company A and Company B, you are on both sides of the transaction and may receive a benefit from the acquisition that, in general, Company A shareholders do not receive.<sup>13</sup> If you receive a substantial benefit from voting in favor of the acquisition, then you cannot be objectively viewed as independent or disinterested, and you are susceptible to a breach of the duty of loyalty claim. In this circumstance, it is imperative that even if the majority of disinterested directors of Company B voted in favor of the acquisition, you did not (in any way) influence the directors' decision to do so. It would, therefore, be prudent to recuse yourself from deliberations concerning the acquisition and to permit a majority of disinterested directors to vote on it.

#### *Taking Out Minority Shareholders or "Going-Private" Transaction*

Assume you are a director of Company C. Company D makes a bid to buy out the minority shareholders of Company C to increase its ownership and take Company C private. Company D offers \$13 per Company C share. What should Company C do in analyzing the offer? What kind of due diligence should Company C undertake to ensure that the deal is fair to its minority shareholders?

As a director, you should ensure that all board members exercise their duty of care by conducting due diligence and by engaging in meaningful deliberations of Company D's bid. It would be prudent to create a special committee of the board composed of disinterested board members. The special committee should also hire independent legal and financial advisers to gather due diligence and to obtain a fairness opinion. These advisers should be independent and have no

conflicts or prior relationships with Company D. The special committee should engage in an arm's length negotiation process and obtain a price that is fair and beneficial to the shareholders. All interested directors should refrain from participating in any deliberations or correspondence regarding this bid offer.

In *Gesoff v. IIC, Inc.*,<sup>14</sup> for example, CP Holdings (CP) owned 80 percent of IIC Industries, Inc. (IIC) and sought to take IIC private by buying out the remaining 20 percent of shares in IIC. CP expected minority shareholders to demand \$16.20 per share, adopted a bid approach, and initially offered \$13 per share.

Thereafter, IIC's board of directors appointed a special committee. The special committee, however, consisted of only one active (and independent) director who approved the transaction by hiring the same financial and legal advisers of CP, settling at \$10.50 per share with no meaningful negotiations with CP and failing to conduct adequate diligence to consummate the transaction quickly at the will of CP.

A former minority shareholder brought a class action against CP and IIC, seeking a statutory appraisal of the price of minority shares.<sup>15</sup> In analyzing the claims, the Delaware Chancery court applied the entire fairness standard of review and found that neither the agreed on price of \$10.50 per share nor the negotiations with CP were fair.

The dealing was unfair because the special committee consisted of only one director who was easily influenced by CP, retained the same legal and financial advisers, failed to engage in "vigorous and spirited" negotiations, failed to seek alternative third-party buyers for the company, and to a certain extent, colluded with CP to consummate the transaction on CP's timeline.<sup>16</sup> The price was unfair because it was less than the illiquid market price of IIC shares and IIC failed to show otherwise; there was no independent evaluation of the price because IIC relied on the valuations of CP's financial advisers.

#### *Raising Capital by Issuing Preferred Stock*

Company X would like to issue \$20 million in preferred stock to Company Y to finance Company X's business expansion strategy. What steps should Company X undertake to be sure that it honors its fiduciary duties to Company X shareholders?

A good example of best practices is *Benihana of Tokyo, Inc. v. Benihana*,<sup>17</sup> where the Delaware Chancery court found that the board of directors exercised due care and loyalty by issuing \$20 million of preferred stock to a holding company. In *Benihana*, plaintiff *Benihana of Tokyo, Inc. (BOT)* sought rescission of an agreement between defendants *Benihana Inc. (Company)* and *BFC Financial Corporation (BFC)* to issue \$20 million of the Company's preferred stock to BFC. The Company entered the agreement to finance the renovation of its restaurant facilities. BOT alleged that the transaction was invalid because, among other things, the Company's directors breached their fiduciary duties of loyalty and care in approving the transaction.

Although BOT claimed that the entire fairness test should apply

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because the director of the Company was also the director of BFC, the business judgment rule applied because the interested director recused himself from deliberations and the vote on the transaction and a majority of disinterested directors voted in favor of the transaction. By applying the business judgment rule, the court found that the transaction was entered into for a proper purpose and that a majority of independent directors approved the transaction. Therefore, no grounds existed for a claim of breach of the duty of loyalty against the director defendants.

Regarding the claim for a breach of the duty of care, the court stated that director liability for breaching the duty of care “is predicated upon concepts of gross negligence,” and in this context, gross negligence is defined as “reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”<sup>18</sup> Applying a standard of gross negligence, the court found that the defendant directors’ conduct did not rise to the level of malfeasance. The court explained that the directors properly exercised their duty of care by, among other things, understanding the purpose of the transaction, reviewing the terms of the agreement, discussing alternative methods of financing, deliberating on objections raised, obtaining a fairness opinion, conducting numerous meetings, reviewing substantive materials, and retaining independent and legal financial advisers.

### *Hiring and Terminating an Executive Officer*

Suppose you are the CFO of Company C and a member of its board of directors. Company C’s CEO passes away from a heart attack. You recommend the hiring of a good friend for the position of CEO as well as the compensation package that Company C should offer. You believe that your friend will serve as an excellent CEO and is fully qualified for the position. How should you present your recommendation to the board, and what steps should you take?

In *In re Walt Disney Co. Derivative Litigation*,<sup>19</sup> Walt Disney CEO Michael Eisner recommended Michael Ovitz for appointment as Disney’s president after the death of its previous president. Eisner and Ovitz had been friends and professional colleagues for almost 25 years. Eisner and the chairman of the Compensation Committee of Disney approached Ovitz about the position, but their initial negotiations failed because Ovitz received an offer from a competing company that Disney could not match.

From this point on, the chairman of the Compensation Committee led negotiations with Ovitz and eventually offered him a five-year contract with two tranches of options.<sup>20</sup> Before the terms of Ovitz’s compensation package were presented to the board, the chairman recruited an executive compensation consultant to analyze the financial terms of Ovitz’s employment agreement. After several negotiations and deliberations with the board, the company hired Ovitz as its president and awarded him a compensation package that included (1)

an option strike price of 100 percent of the company’s stock price on the day of the grant for 2 million options that would become exercisable in the sixth and seventh year of Ovitz’s employment, (2) a \$10 million severance if the company did not renew Ovitz’s contract, and (3) a \$1.25 million annual salary.

Fewer than 14 months later, Ovitz was performing poorly and the Disney board determined that it should terminate his employment.<sup>21</sup>

The directors found that they could not terminate Ovitz for cause because he had neither breached any material term of his employment agreement nor committed any wrongdoing. Therefore, they had no choice other than to honor Ovitz’s employment contract by paying him a severance worth roughly \$130 million, despite his relatively brief service as president. Soon thereafter, class representative shareholders sued the company’s directors for breach of the duty of care and waste of corporate assets for having approved Ovitz’s employment agreement in the first place.

Upon applying the business judgment rule, the Delaware Supreme Court found that the directors neither breached their fiduciary duties nor wasted corporate assets because the directors acted in good faith, were not conflicted, and made decisions based on the best interests of the company at that time. The court explained, “[o]ur law presumes that ‘in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.’”<sup>22</sup> The class representative plaintiffs never rebutted this presumption.

The court also explained that there was ample evidence showing the directors were adequately informed regarding the terms of Ovitz’s employment agreement. On the basis of the minutes of the compensation committee, the court found that the committee knew that if Ovitz was terminated, the severance payout would be approximately \$130 million. The court emphasized that the compensation committee obtained independent financial opinions approving Ovitz’s employment agreement and that the figures in Ovitz’s employment agreement was based on substantial documented negotiations and deliberations. Agreeing with the trial court, the Delaware Supreme Court therefore found that the “directors were informed of all information reasonably available and thus were not grossly negligent.”<sup>23</sup>

Although the Delaware Supreme Court found in favor of the defendant directors, Walt Disney teaches valuable lessons and shows that the following steps should be taken before directors begin negotiating with a prospective executive:

- Communicate the qualifications of the prospective executive to the board at formal board meetings.
- Obtain official authority to act and negotiate with the prospective executive from the board.
- Discuss the terms of the offer and employment package at formal board meetings.

*(Continued on page 13)*

- Hire independent financial and legal experts and counsel to determine whether the compensation package is in line with market and industry standards.
- Provide all directors the opportunity to review the proposed compensation package.
- Document the negotiation process and the reason for accepting different terms in meeting minutes.

#### *Fiduciary Duties for Directors of Insolvent Companies and Their Subsidiaries*

Assume you are a director of a wholly owned subsidiary that is bankrupt. Despite this, you authorize the subsidiary to enter into sale-and-leaseback agreements concerning real estate holdings and the subsidiary subsequently divests itself of the real estate holdings, by selling real estate to entities controlled by you on unfavorable terms. The trustee of the wholly owned subsidiary sues you for breach of fiduciary duty on behalf of the creditors of the parent corporation, the wholly owned subsidiary, and the creditors of the wholly owned subsidiary. Can the trustee pursue these claims on behalf of all these entities?

Certainly. Under Delaware law, directors and officers of an insolvent wholly owned subsidiary owe fiduciary duties to the subsidiary and parent corporation as well as to their creditors.<sup>24</sup> Directors of an insolvent corporation owe fiduciary duties to the corporation's creditors. These duties are "typically derivative of those the directors owed to the subsidiary corporation itself."<sup>25</sup> Therefore, "if the subsidiary's creditors are said to be owed a fiduciary duty upon insolvency, the subsidiary itself must also be owed such a duty."<sup>26</sup> In Delaware and several other jurisdictions, even when a company is in the "vicinity of insolvency,"<sup>27</sup> directors owe fiduciary duties to the corporate enterprise, which is a "community of interests" that includes stockholders, creditors, employees, and any other group interested in the corporation.<sup>28</sup> When a company nears bankruptcy, therefore, directors have an obligation to exercise judgment in an informed, good faith effort to maximize the company's long-term wealth-creating capability.

In the foregoing hypothetical, the directors of the wholly owned subsidiary should have solicited and considered third-party offers for purchase of the real estate. The directors also should have sought independent review by financial and legal experts, ensured that a majority vote of disinterested directors approved the transactions, and verified the business purpose of each decision made concerning the transactions.

If a company is insolvent (or in some jurisdictions, in the vicinity of insolvency), directors and officers must evaluate what actions will maximize the value of the company to the benefit of the company, shareholders, and creditors. The following are guidelines for directors and officers of insolvent companies that help ensure compliance with fiduciary duties:

- Gather and review all material information relating to every business decision.

- Evaluate the impact of business decisions on the company's creditors and shareholders.
- Consider creating subcommittees to review certain issues and seek independent legal and financial advice.
- Keep detailed minutes of board meetings describing issues raised by the board prior to making a decision.
- Maintain detailed written reports identifying the materials that directors and officers reviewed.
- Limit or avoid transactions with insiders or other conflicted individuals.<sup>29</sup>

#### **Conclusion**

Directors perform a crucial role in overseeing the management of a company's business affairs. Their decisions are appropriately deferred to under the business judgment rule. Yet directors should be aware of instances in which the benefit of the business judgment rule is unavailable, and they should understand how best to discharge their duties of loyalty and care in those circumstances. After all, what could be more unpleasant and financially risky for a seasoned director than seeing the legacy of his or her otherwise devoted and exemplary service crushed by a freight train of litigation that was in plain view and avoidable in advance of a major board decision? This discussion has illustrated why and how directors should, at all times, take reasonable measures to inform themselves, to avoid self-interested transactions, and to act in the best interests of the company and its shareholders and in good faith. In other words, when the board on which you or your client serves confronts its next major decision, remember or advise your client to stop, look, listen . . . and exercise independent judgment. ◊

- 1 Dan A. Bailey, J. David Washburn & Quentin Collin Faust, *Now It's Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers*, WALL ST. LAWYER, Sept. 2002.
- 2 Towers Perrin, *Directors and Officers Liability: 2006 Survey of Insurance Purchasing and Claims Trends* 56 (2006).
- 3 This responsibility is found in the Model Business Corporation Act, which most state corporate statutes follow: "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement."
- 4 *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 971 n.16 (Del. Ch. 2003); see also Lymon P.Q. Johnson, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 Wm. Mitchell L. Rev. 1149, 1192 (2004); Gary W. Marsh, *The Many Faces of Directors' Fiduciary Duties*, 22 AM. BANKR. INST. J. 14 (Sept. 2003).
- 5 *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).
- 6 *In re Tyson Foods, Inc.*, 919 A.2d 563, 592 (Del. Ch. 2007).
- 7 *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005).
- 8 *Id.*; *Benihana of Tokyo, Inc. v. Benihana*, 891 A.2d 150, 154-55 (Del. Ch. 2005); *Orman v. Cullman*, 794 A.2d 5, 41 (Del. Ch. 2002).

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a "pride provision," are included so that a professional has a measure of control to protect his reputation.<sup>1</sup> Settlement of professional negligence claims may impact not only the professional's reputation but may also impact his ability to procure future employment, obtain staff privileges for physicians, and purchase professional liability insurance in the future. Indeed, this issue is particularly important for the medical profession when settlements may trigger reporting obligations to state and/or federal data banks.<sup>2</sup>

In order to balance the control ceded to an insured through a consent to settle provision, many professional liability insurance policies contain a provision known colloquially as "the hammer clause." A typical "hammer clause" provides:

If the Insured shall refuse to consent to any settlement or compromise recommended by the Insurer and acceptable to the claimant and elects to contest the claim, the Company's liability for any damages and claims expenses shall not exceed the amount for which the claim could have been settled, less the remaining deductible.

Essentially, the hammer clause enables the insurer to limit its exposure to the amount for which the claim could have been settled (plus past costs and expenses), notwithstanding that the actual policy limit was far greater than the acceptable settlement amount. As the hammer clause may act to limit coverage and/or shift risk, it is an important consideration in a discussion of consent to settle provisions and who is entitled to exercise the right of consent.

In *Jayakar v. North Detroit General Hospital*, the physician plaintiff sued the hospital and its insurer for damages resulting from the settlement and reporting of a medical malpractice suit against him.<sup>3</sup> The insurance policy authorized the insurer to settle any claim "with the written consent of the Insured." The term "Insured" was defined to include any employee while acting within the scope of his duties.<sup>4</sup> Based on this policy language, plaintiff argued that the insurer was required to obtain his consent before settling the case. In dismissing plaintiff's claim, the court considered "the language of the contract and the context in which it [was] used." The court held that:

The correct interpretation of the insurance contract is that when a claim is filed against an additional insured and defendant hospital, the power to consent to a settlement vests only in defendant hospital as the named insured.<sup>5</sup>

In *Webb v. Witt*, a New Jersey court reached a conclusion contrary to that of the Michigan court in *Jayakar*.<sup>6</sup> There, *Webb* brought a medical malpractice action against several physicians and the hospital in which they were employed. The doctors were afforded insurance coverage by the hospital's insurer pursuant to a policy which stated:

[Insurer] shall not settle or compromise any claim or suit without the approval of the Named Insured and in accordance with instructions transmitted by the Named Insured to [Insurer] or its authorized Claims Management Organization...<sup>7</sup>

The New Jersey court noted the fundamental principle that an insurance policy is a contract, the clear terms of which should be enforced by the court.<sup>8</sup> Further, the court noted that the clear language of the subject policy required consent to settle only from the "named insured" and did not provide this right to other insureds. The court rejected the doctor's contention that the absence of a consent to settle clause was against public policy. The court concluded that:

We do not mean to suggest that consent to settle clauses in insurance policies are unenforceable. However, such a clause must be expressly stated; it cannot be implied. We will not reform a policy to include such a term.<sup>9</sup>

Since the policy limited the right to consent to the hospital as "named insured," the court rejected the doctor's arguments that, either by contract or public policy, his consent to settle was required.

Review of the *Jayakar* and *Witt* decisions leads to the conclusion that these courts could reach different results under Scenario I presented above. In reaching its result, the Michigan court appeared most concerned with the practical difficulties which could ensue if the right to consent was vested in every employee or volunteer who fell within the definition of "insured" under the hospital's insurance policy. In contrast, the New Jersey court applied the strict terms of the insurance contract which delegated the consent to settle solely to the "named insured." By logical extension, it seems the New Jersey court would have concluded that Dr. *Jayakar's* consent to settle was required since the subject policy referred to "the written consent of the Insured," and was not restricted to the "named insured."

Most professional liability insurance policies contain definitions of the terms "named insured" and "insured." It is important for defense counsel appointed by an insurer to understand the consent to settle provision contained in the policy pursuant to which he is appointed and also to understand the definition of "named insured" and "insured" as used in the specific policy at issue. Settlement of a professional negligence claim without the consent of the insured contrary to the policy provisions can subject defense counsel to a legal malpractice claim. In *Lieberman v. Employers Insurance of Wausau*, the court held that defense counsel appointed by an insurer committed legal malpractice by ignoring the wish of his physician client to litigate rather than settle.<sup>10</sup>

The "named insured" of a professional liability insurance policy is generally the entity to whom the coverage is issued or the first named professional in an unincorporated entity or association. However, the term "insured" is usually much broader and includes other professionals acting within the scope of their duties as well as other employees of the named insured. Before negotiating a settlement of a professional negligence claim, defense counsel should determine the identity of the named insured, other insureds, and whether the right to consent to settlement is limited to the named insureds.

Although it is most common that claimant's counsel will join in a professional negligence action the individual professionals who allegedly committed malpractice as well as the entity which employs them,

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## CONSENT TO SETTLE ...

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this is not always the case. Consider scenario no. 2 in which the individual attorney, now no longer employed by the named insured law firm, is sued but the law firm is not. If the subject insurance policy requires consent of the named insured, the ability to control settlement rests with an entity which is not a party to the litigation. Interestingly, in this situation, the insurer would also lose the effectiveness of the hammer clause since the party refusing to consent is not at risk of an excess judgment or large defense costs since it is not a party to the litigation. In that situation, the individual attorney would be at the whim of his former law firm whose refusal to consent to settle may be based primarily on considerations of the size of the applicable deductible and their loss experience which may affect future insurance premiums.

In this same scenario, if the law firm consented to settle, but the individual attorney did not, it appears that jurisdictions will differ on whose consent is required before a settlement may be effectuated. Moreover, in some jurisdictions, the result will be dependent on the policy language and whether the consent requirement is extended to all insureds or limited to the named insured.

A practical issue which often arises in the context of discussions of consent to settle is responsibility for payment of a policy's deductible or self-insured retention. Unfortunately, there is little decisional law available on this issue. However, the various factual scenarios raise many interesting questions. For example, if the right to consent to settle rests with the named insured only, and a matter is settled over the objection of an "other insured," is the named insured the only party responsible for payment of the deductible? Conversely, if the individual professional is the sole defendant and consents to settlement over the objection of the named insured who is not a party, who is obligated to pay the deductible? Since deductibles and/or self-insured retentions can range from \$2,500 to \$500,000 and beyond, these questions often involve significant financial consequences.

Given the various factual scenarios which may develop, and given the limited authorities available to provide guidance on the issues, pragmatic defense counsel will try to avoid loose ends. This can be done by obtaining written consent to settle from all parties being represented by the defense counsel in the matter. Further, defense counsel should specifically address his clients, the insureds, with respect to the issue of both the size and responsibility for payment of the deductible or self-insured retention. It is best to address the issues of consent to settle and responsibility for payment of the deductible early in the litigation process and, in any event, before opening settlement negotiations with the claimant. Doing so will lessen the chances for a subsequent legal malpractice action against defense counsel and will also lessen the likelihood that settlement negotiations with claimant break down due to the inability of defendants to agree internally on these issues.

Clearly, defense counsel needs to know the relevant terms of

the policy pursuant to which he has been appointed to provide representation to the insureds. Further, defense counsel needs to orchestrate the consent of the insureds to settle as may be required by the policy provisions. To the extent that issues arise between insureds with respect to their consent to settle and responsibility for a deductible, defense counsel will then have positioned the issue for resolution with the insureds and the insurer in a timely fashion. Defense counsel is not coverage counsel, and therefore, cannot become embroiled in any disputes among the insureds or between the insureds and the insurer. Nevertheless, the consent to settle issue is one which necessarily involves defense counsel, particularly in light of the professional liability implications it has for defense counsel. In sum, caution is the byword for defense counsel in dealing with policies that have consent to settle provisions.

- 1 *Brion v. Vigilant Ins. Co.*, 651 S.W.2d 183 (Mo. Ct. App. E. D. 1983).
- 2 *See generally* Health Care Quality Improvement Act of 1986, 42 U.S.C.A. §11101 *et seq.*; 45 CFR §60.5(a).
- 3 *Jayakar v. North Detroit Gen. Hosp.*, 451 N.W.2d 518 (Mich. App. 1989).
- 4 *Id.* at 519.
- 5 *Id.*
- 6 *Webb v. Witt*, 876 A.2d 858 (N.J. App. Div. 2005).
- 7 *Id.* at 861.
- 8 *Id.* at 866-867.
- 9 *Id.* at 867.
- 10 *Lieberman v. Employers Insurance of Wausau*, 419 A.2d. 417, 424 (N.J. 1980).

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## LITIGATION SETTLEMENTS BY INDIVIDUAL OUTSIDE DIRECTORS AND D&O INSURANCE ...

*(Continued from page 1)*

own pockets, despite their status as outside directors not directly involved in the alleged wrong-doing. This demand that the settlements include personal payments by these individuals occurred despite the existence of D&O insurance policies. As with the recent *Just for Feet* settlement, these individuals were not the corporate insiders who allegedly orchestrated the frauds; these outside director defendants appear to have been accused of no more than failing to detect and correct the fraud of others while they served on the boards of directors. The individual outside directors agreed to pay \$13 million to settle in *Enron* and \$20.2 million in *WorldCom*.

With some limited, noteworthy exceptions, D&O insurance has generally worked well at protecting outside directors. Settlement payments made personally by outside directors remain relatively rare. Indeed, Professors Klausner, Black and Cheffins' extensive research found just thirteen examples in which outside directors of public companies made out-of-pocket payments to settle securities litigation. They conclude that most of those examples involve fact patterns that should not recur for a company with a state-of-the-art D&O insurance policy.<sup>3</sup>

If the goal is to protect inculpable individual directors, perhaps common D&O insurance policy wording should be re-examined. Traditionally, D&O insurance was designed to protect the personal assets of individual directors and officers.

There was no direct coverage for the company itself. Over the years, coverage under D&O policies has evolved and become broader. D&O policies now usually have three standard insuring clauses: side-A, providing personal coverage for the individual directors or officers if corporate indemnification is not available; side-B, providing corporate reimbursement coverage for the corporation's responsibility to indemnify its directors or officers; and side-C or "entity coverage," providing coverage for certain claims against the corporation itself (usually limited to securities claims), even if no individual director or officer is named as a defendant. This broadening of coverage can have the effect of actually lessening the protection for the innocent outside director, because D&O policies typically offer a single aggregate limit for all coverage parts including applicable defense costs.

This broadening of coverage can create a conflict of the D&O policy as corporate bottom line protection versus the D&O policy as protection for the individual directors and officers. The primary and historic purpose of a D&O policy should be to protect the individual insureds, but many D&O policies have added features that can dilute the ability of the policy to protect those individuals. Perhaps it is time to re-focus D&O insurance on protecting outside directors who can unwittingly become defendants merely for serving on the boards of

publicly held corporations.

### Entity Coverage

Entity coverage may have increased the settlement amounts in some securities cases, and it adds to the problem of the policy limits being eroded before they can be used to protect the individual defendants. Over 94% of public company D&O insureds in the United States report having entity coverage.<sup>4</sup> Entity securities coverage provides coverage for the company itself for securities claims brought against it. Since most securities cases name both the company and individual directors and officers as defendants, cases without entity coverage usually involve long negotiations over an allocation of what is covered under the D&O policy and what needs to be paid by the uninsured corporation itself. Prior to entity coverage, typically a 50% to 70% allocation of coverage between the insured D&O and the uninsured corporation was negotiated; with entity coverage, there is no such allocation.<sup>5</sup> However, entity coverage can reduce the amount of coverage available for individual directors and officers, as policy limits otherwise available to protect the individual directors and officers are eroded by the corporation's own liability.

Since the widespread adoption of entity coverage, D&O insurers no longer share the costs of defending and settling securities class action cases with corporate defendants. With policies that eliminate contributions from the corporations towards settlements within policy limits, insureds have different economic incentives than if they

would otherwise have to pay a portion of any settlement or judgment. This lack of incentive can lead to defense counsel and plaintiffs' counsel forging expedient alliances where the mutual goal is a quick settlement without regard to the merits of the claim, within the available insurance limits, and at

little or no cost to the insureds.<sup>6</sup> In the long run, the resulting overpayments on non-meritorious cases cause a ripple effect on other cases, compounding the average settlement value for shareholder cases, which is in turn used to justify even higher settlement demands in the future.<sup>7</sup> At the same time, settling at a higher point within policy limits lessens the amount available to cover outside directors in later claims. The more that the D&O policy limits must be spent on resolving securities litigation against a company, the less that will remain available to defend any later claims asserted against that company's individual outside directors. To try to prevent this, coverage might be altered with refined co-insurance plans, exclusion triggers, severability language, or with additional "Side-A Only" coverage.

### Co-Insurance

D&O insurers have promoted co-insurance as a way of securing more active involvement from the insured. With co-insurance the corporate policyholder agrees to pay a pre-set percentage of losses under the policy. The hope is to better unify the interests of the insured and insurer by creating an economic incentive for both to nego-

**"With some limited, noteworthy exceptions, D&O insurance has generally worked well at protecting outside directors."**

*(Continued on page 18)*

## LITIGATION SETTLEMENTS BY INDIVIDUAL OUTSIDE DIRECTORS AND D&O INSURANCE ...

*(Continued from page 17)*

tiate the lowest possible settlement or resolution of the litigation. Significant co-insurance on side-B and side-C (but not on side-A) should have the effect of preserving policy limits for the protection of inculpable outside directors. However, the current softening D&O insurance market has caused co-insurance to largely vanish, despite its potential to benefit individual outside directors.

### **“Final Adjudication” Language**

Even though most securities claims include allegations of fraud or dishonest acts, D&O policies usually exclude coverage for such conduct. In some D&O policies, these exclusions require the trigger of a “final adjudication.” This leaves open the possibility that one individual insured “bad actor” could exhaust the entire policy limits before a “final adjudication” of his or her misconduct. Some carriers are modifying some of these important exclusions (such as fraud and dishonesty) by changing the wording from “final adjudication” to “in fact,” or other wording that defines when these exclusions apply. If done correctly, this wording should allow for a quicker exclusion of coverage for the “bad actors” who have in fact engaged in excluded wrongdoing, as exclusion would not have to wait for a “final adjudication” of the alleged misconduct. Thus, moving away from “final adjudication” language should lessen the likelihood that policy limits will be exhausted before they can be used to defend and protect the inculpable directors.

### **Severability Language**

In the context of D&O insurance, severability refers to a provision in the policy that states that, for purposes of determining coverage under the policy, the acts or knowledge of certain insureds will not be imputed to other insureds. Changes in severability language, such as full severability for the outside directors and no severability for the entity, can be written into D&O policies to help with the protection of inculpable outside directors.

Severability is often discussed in terms of what knowledge from the insurance application will be imputed to all of the insureds. Some individual insureds worry that their D&O coverage may be voided because another insured knew information that was not truthfully disclosed to the insurer in the underwriting process. At the same time, insurers who are induced to issue a D&O policy based upon false representations by the insureds do not want to pay millions of dollars under such circumstances, since the insurer may see itself just as much a victim of the misrepresentations as the plaintiff shareholders.

Applications for D&O insurance usually incorporate important information relied on by the underwriters to assess the risk, including the insured corporation’s financial statements and certain SEC filings. There has been an increase in companies restating their financial statements. This increase in restatements has led to an increase in

concern about the possibility of D&O policies being rescinded<sup>8</sup> and more questions about severability.

If there is no severability provision in a D&O policy, the insurer may be allowed to rescind or void the entire D&O policy for all insureds based on a misrepresentation of material facts in the underwriting process.<sup>9</sup> This approach may protect the insurer but can expose the inculpable individuals to uninsured personal liability if other insureds misrepresented material information to the insurer.

Full severability provides the insurer with little protection from application misrepresentations. Unable to correctly evaluate the risk presented, the insurer issues a policy based upon material misrepresentations in the application. If a securities class action lawsuit follows, being able to deny coverage to the individual perpetrators is small consolation for the insurer exposed to potentially large losses on behalf of the insured company and the other individual insureds.

As a compromise between “full” severability and “no” severability, some D&O insurers are now providing a form of “partial” or “limited” severability. One approach is to restrict the extent of imputation so that only the knowledge or conduct of certain named key executives is imputed to all other insureds.<sup>10</sup> Another variation of limited severability offered by some carriers is to impute knowledge or conduct: (1) to those insureds that were aware of it, and (2) to all insured companies or entities. This variation of limited severability should have the effect of paring down coverage to side-A for the inculpable insureds and thereby providing them with the safety net they need. Some D&O policies now contain a promise not to rescind coverage for individual insureds under the Side-A coverage.

### **Policies for the Individuals (Side-A Only)**

The broad coverage of most D&O policies and the apparent willingness to exhaust entire D&O insurance programs to resolve the entity’s alleged wrong-doing can leave unwitting individual directors or officers without any policy limits left for subsequent claims against them. These concerns, and concerns regarding bankruptcy issues,<sup>11</sup> have led to increasing interest in Side-A only policies. The former chairman of the Securities Exchange Commission, Harvey L. Pitt, has recommended that outside directors look into excess side-A coverage when the companies standard policies do not fully protect the outside directors.<sup>12</sup> Side-A only policies have insuring clauses that provide personal coverage for the individual directors and officers without corporate indemnification. Side-A coverage most frequently applies: (1) if the company is bankrupt or financially insolvent or (2) if the company is prohibited from indemnifying the intended directors or officers (such as in some derivative lawsuits).

Many companies have taken steps to obtain this type of protection for their directors. According to the recently released 2006 Towers Perrin Survey of Insurance Purchasing and Claims Trends, 38% of public companies in the survey reported purchasing a Side-A only D&O product. More D&O carriers are now offering a type of Side-A only policy (sometimes called Side-A DIC (“Difference in Conditions”)) that provides additional protection for individual insureds in the event

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the underlying D&O coverage is unavailable or even rescinded. These Side-A only policies sit excess of traditional D&O policies but can drop down to protect the individuals if the regular D&O coverage is not available. A feature of some of these policies is non-rescindable coverage for non-indemnifiable loss.

A Side A-only policy could potentially have provided protection in the recent *Just for Feet* litigation. The *Just for Feet* settlement may provide one of the best recent examples of the need for separate Side A-only policies dedicated solely to the outside directors' protection.<sup>13</sup> The existence of separate limits that cannot be depleted in resolution of others' claims is the best protection against the possibility that unwitting individuals might be left to face their own liability exposure without insurance protection.

### Conclusion

Unwitting individual outside directors should not have to worry that they are putting their personal assets at stake by serving on the boards of public corporations. Perhaps some of the best D&O insurance protection for outside directors is a program of traditional Side-A, Side-B and Side-C (entity) coverage with a significant excess layer of Side-A only coverage to protect the individuals if the underlying program is exhausted or otherwise unavailable. A careful reworking of traditional D&O insurance policies to include language that gives the insureds, the carriers, and the courts the tools to protect inculpable outside directors, coupled with the use of Side-A only policies on top of these carefully worded traditional D&O policies, should go a long way towards achieving the desired protection and thus encourage the best and brightest to serve on boards of public corporations. ◊

- 1 See "Protecting The Innocent Outside Director After Enron and World-Com" by Michael Early, *International Journal of Disclosure and Governance* Vol. 2 No. 2 (June 2005).
- 2 April 23, 2007 Wall Street Journal article entitled "Settlement in Just for Feet Case May Fan Board Fears".
- 3 Outside Director Liability by Bernard Black, Brian Cheffins and Michael Klausner, 58 *Stan. L. Rev.* 1055, (March 9, 2006).
- 4 Tillinghast-Towers Perrin "2004 Directors and Officers Liability Survey" at p. 42.
- 5 Entity coverage does have the desirable effect of usually making unnecessary the potential disagreement between the insurer and the insured as to the percentage of allocation. Some D&O carriers offer policies with pre-set allocations as another way to avoid this potential future disagreement over allocation percentages.
- 6 On the short end of such arrangements are the hapless D&O insurers, passively funding the multi-million dollar settlement.
- 7 "Settlements have skyrocketed since the introduction of entity coverage, because corporations no longer have a vested financial interest in mitigating damages – only in settling suits within policy limits." *PLUS Journal*, September 2003, "The D&O Market – One Year After the White Paper" by Daniel Aronowitz.
- 8 The requirements for rescission vary from state to state, but generally rescission requires some or all of the following five elements: (1) the making of a representation; (2) the falsity of that representation; (3) the materiality of the misrepresentation; (4) the insurer's reliance on the misrepresentation; and (5) the insured's knowledge of the representa-

tion's falsity (i.e. scierter). Almost all states require the first four elements but only some states require the fifth element. "D&O Policy Commentary" from the Institute for International Research D&O Liability Insurance Conference September 2003 at p. 16 by Dan Bailey.

- 9 Courts have consistently ruled that D&O insurance policies are "unitary" contracts, and therefore absent a severability provision, the entire policy can be void with respect to all insureds if any one insured misrepresents information to the insurer in the underwriting process.
- 10 While broader than granting no severability, this approach to limited severability still leaves the possibility of all "innocent" insureds being denied coverage if certain individuals had knowledge of false information.
- 11 Some D&O policies with entity coverage have been treated as assets of a company's bankruptcy estate, allowing bankruptcy assets to interfere with the payment of defense expenses and settlements in securities class action cases.
- 12 "Whither Directors' Personal Liability?" *Compliance Week*, January 25, 2005, by Harvey L. Pitt ("In addition to broad rights of indemnification under corporate charter, comprehensive insurance coverage is essential because directors may incur personal liability, . . . Outside directors should look into excess 'Side A' coverage, which protects innocent outside directors when the company's standard policies are rescinded or do not fully protect the outside directors.").
- 13 Kevin La Croix *The D&O Diary* "Outside Director Exposure: A Recent Settlement Raises Alarms" April 23, 2007.

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