SmorgasBoard

THE MENU OF D&O EXPOSURES IS EXPANDING AS PLAINTIFF'S ATTORNEYS INNOVATE, REGULATORS ENCROACH AND SHAREHOLDERS DEMAND MORE.

BY DAVID TOPOL, JUSTIN KUDLER AND LELAND JONES

Directors of publicly traded companies face growing responsibilities and exposures in the current complex business and regulatory environment.

Securities lawsuits over purportedly misleading statements to shareholders are normally filed against the corporation and its officers, not directors, but their prevalence and costs can be a drain on corporate funds and on company management's attention. There are 5,743 companies publicly listed in the United States, and 5.2% of those companies faced a securities class action in 2016 alone, according to NERA Economic Consulting. Directors must ensure that the company has robust internal controls and accounting guidelines to mitigate the chance that management and the company are sued in securities litigation alleging that the officers and the company made materially misleading statements to investors.

Apart from protecting against securities lawsuits against the company, directors increasingly are threatened with derivative actions and regulatory investigations and proceedings, leaving them exposed to potential civil and criminal liability. Directors also face potential liability exposures in new areas, whether prompted by increased government focus or simply because of the litigious environment.

Enterprise Risk Management: In February 2010, the U.S. Securities and Exchange Commission issued regulations requiring corporate boards to provide additional disclosure about the board's oversight of enterprise risk management. Spurred by the financial crisis of 2007-2009, the SEC wanted boards to focus on potential over-exposure to particular risks, such as certain financial instruments, lines of business, or potentially troublesome links in a supply chain. Enterprise risk management requires the board to be actively engaged in the full spectrum of risks faced by the company and to ensure that protocols are in place to manage those risks. When done effectively, it can ensure that risks faced by the company have been identified and the board or a board subcommittee has taken responsibility for ensuring adequate oversight of management's ongoing duty to address and mitigate the risk.

The Yates Memo requires DOJ attorneys to focus on individual wrongdoing; requires corporations to disclose the names of individuals involved in alleged corporate misconduct to receive consideration for cooperating with a DOJ investigation; and directs civil attorneys to consider bringing suits against individuals as well as corporations for corporate wrongdoing.

Cyber: Most companies face significant cyber risks, including data breaches. In the first half of 2016 alone, there were 974 publicly disclosed data breaches of companies and governmental institutions, according to the Breach Level Index published by digital security provider Gemalto.

In two high-profile breaches, Home Depot and Target reported total data breach expenses of $63 million and $162 million, respectively. Companies that are subject to data breaches also face potential investigations and enforcement actions by the Federal Trade Commission for failing to secure client data and may face state attorney general investigations if the company does not comply with breach notice laws, which vary by state.

If a breach occurs, directors may face lawsuits alleging that they breached their fiduciary duties to the company by failing to take the necessary steps to prevent the breach. Boards can more effectively defend themselves against potential derivative suits by taking proactive steps to ensure management and the company's internal and external information technology specialists are identifying potential cyber risks regularly and have plans in place to address those risks.

Foreign corrupt practices: Directors also face risks associated with their company's international dealings. The Foreign Corrupt Practices Act is a federal statute that prohibits U.S. businesses and citizens from making payments to foreign government officials to obtain preferential treatment from the foreign government. Additionally, boards are charged with ensuring companies have accurate books and records documenting corporate payments and strong internal controls to prevent corporate funds from being utilized to make payments in violation of the FCPA. In fiscal year 2016, the SEC brought 20 proceedings related to alleged FCPA violations, and the U.S. government resolved FCPA cases against 13 corporations resulting in payment of over $1 billion in total fines, penalties and forfeitures.

In 2016, the U.S. government announced an FCPA pilot program by which companies would receive preferential treatment if they self-reported potential FCPA violations, cooperated with the government, and remediated deficiencies in compliance programs. That program potentially allows the government to decline to pursue the corporation for FCPA violations, and thus, corporate boards are incentivized to initiate robust investigations of potential FCPA issues and timely investigate and report any potential violations to the government.

Potential Vectors of Liability

The principal litigation risk for directors is derivative lawsuits by shareholders. In derivative actions, shareholders file suit on behalf of the corporation against directors for alleged breach of fiduciary duties. Normally, the company's board makes decisions about which suits the corporation will file, but in derivative actions, plaintiffs assert that it would be futile to make a demand on the board to initiate a lawsuit against some or all members of the board of directors. The principal risk associated with an adverse determination in a derivative action is that a director would likely not be entitled to indemnification from the company, thus creating the potential for the director to owe a judgment out-of-pocket.

Directors often face derivative lawsuits over the approval of any significant corporate transaction, such as a merger or acquisition. According to Cornerstone Research, in 2015, 84% of corporate transactions valued at over $100 million were subject to one or more derivative lawsuits filed against directors. Those lawsuits allege that the directors breached their fiduciary duties to the company by approving a merger or other corporate transaction for which the directors allegedly did not make all material disclosures for the shareholders to consider whether to approve the transaction. These lawsuits also often allege that the corporate transaction was not subject to a fair process and resulted in an inadequate price for the actual value of the company's shares.

Although traditionally these merger objection lawsuits were filed in Delaware and other state courts, more of them are being filed in federal court and alleging violations of federal securities laws. According to NERA Economic Consulting, plaintiffs filed 300 federal securities class actions in 2016 versus the average 221 federal securities class actions filed annually from 2011 to 2015. The main driver for the increase in federal securities lawsuits was 88 lawsuits filed in 2016—versus 44 in 2015—that alleged federal securities law violations associated with a merger.

Directors of publicly traded companies also face potential exposure in investigations and enforcement proceedings from a wide variety of governmental authorities. The SEC opened 1,063 informal investigations in fiscal year 2016 and issued 681 formal orders of investigation, allowing SEC staff to issue subpoenas and take testimony from witnesses as a precursor to a potential civil or administrative enforcement action. The number of investigations opened and formal orders of investigation in 2016 ticked up slightly from 2014 and 2015.

Indemnification even extends to a criminal action or proceeding if the director had no reasonable cause to believe his conduct was unlawful.

To assist with obtaining information about potential securities law violations, the 2010 Dodd-Frank Act authorized the SEC to establish a whistleblower program. Whistleblowers are awarded between 10% and 30% of any SEC recovery in excess of $1 million for providing original information that leads to a successful SEC action. In 2016, the SEC received 4,218 tips from purported whistleblowers. These tips can lead to informal or formal investigations of the company and its directors. And even if no enforcement action is filed, the board will likely be required to retain outside counsel to assist with the internal investigation into potential wrongdoing and to assist in persuading the SEC not to bring an enforcement action.

The U.S. Department of Justice also investigates directors of publicly traded companies for potential violations of federal criminal laws ranging from antitrust violations to securities and financial fraud. To assist the DOJ with its investigation, the DOJ may empanel


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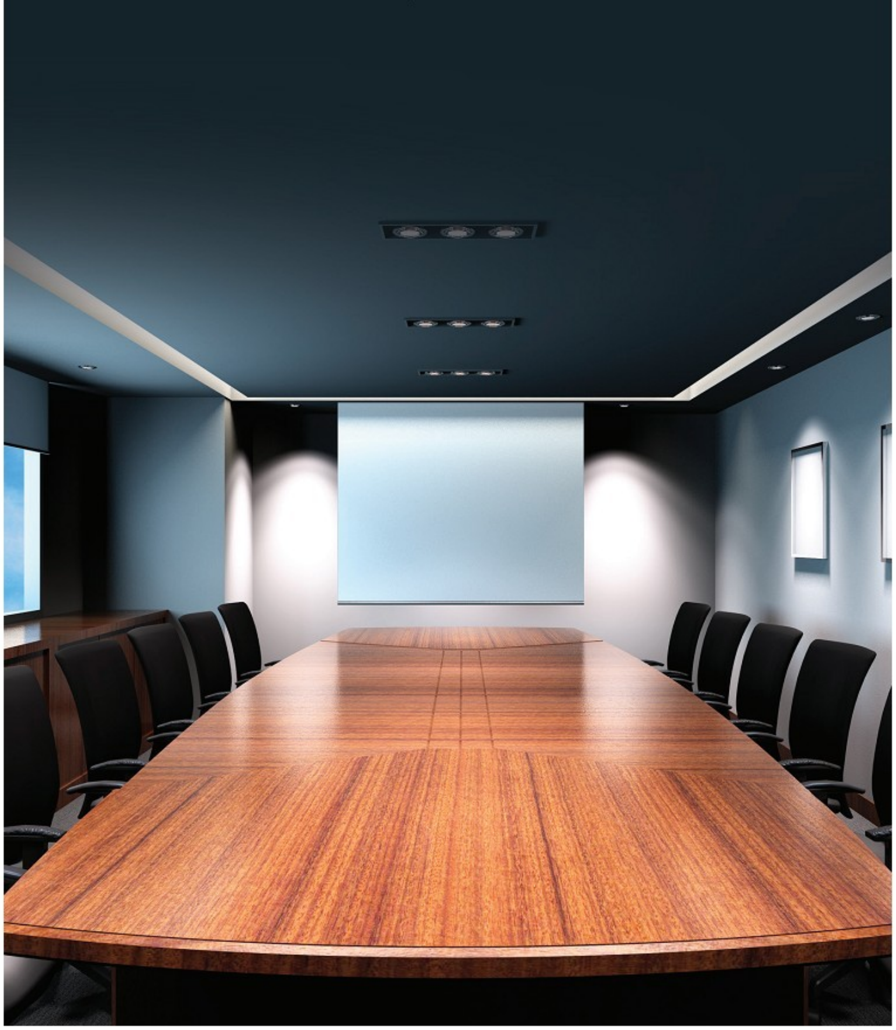
D&O Insurance Covers Board and More

Another bulwark of protection is directors and officers liability insurance. This insurance provides coverage for the defense and settlement of specified claims against directors, as well as companies. Directors should be sure that the company purchases substantial D&O insurance from highly rated insurance carriers to protect directors against the numerous liability risks they face. Brokers can provide important insight as to the amount of insurance potentially needed, the policies' terms and conditions, and which D&O insurers have the financial wherewithal and industry reputation to be a partner in defending and potentially settling claims.

Because D&O policies often afford coverage for the corporate entity, the policy limits may be exhausted by claims against the company, leaving the directors exposed to paying defense costs and/or settlements or judgments out-of-pocket. A director may face out-of-pocket exposure if the company is unable to provide indemnification because it files for bankruptcy or for other reasons. Corporations often purchase separate insurance policies to protect directors in these circumstances. Called "Side-A" insurance, from the insuring agreement in D&O policies that typically provide indemnification for individuals, these policies provide protection only for directors and officers and may afford broader protection than D&O insurance that covers both companies and directors.



a grand jury to issue subpoenas and hear testimony regarding potential criminal violations to determine if the DOJ has enough evidence to charge an individual. In 2016, the Fraud Section of the DOJ charged 300 individuals with federal crimes and convicted 201 individuals. The Securities and Financial Fraud Unit of that section charged 52 individuals and convicted 35 individuals in 2016.

The DOJ under the Obama administration placed emphasis on holding individuals accountable for alleged corporate wrongdoing in civil and criminal cases. In the so-called "Yates Memo," the DOJ set forth guidelines by which it sought to prevent civil or criminal wrongdoing against corporations from being resolved without an investigation into the potential misconduct of individuals acting on behalf of the corporation. The Yates Memo requires DOJ attorneys to focus on individual wrongdoing; requires corporations to disclose the names of individuals involved in alleged corporate misconduct to receive consideration for cooperating with a DOJ investigation; and directs civil attorneys to consider bringing suits against individuals as well as corporations for corporate wrongdoing.

It is uncertain how the SEC and DOJ in the Trump administration will prioritize enforcement against both companies and individuals. As with any change in administration, there is new leadership at both the SEC and the DOJ, and it is not yet known to what extent those leaders want to continue the enforcement priorities from the Obama administration. The change could result in an adjustment to the number of enforcement actions as well as the types of actions being pursued by the government.

Tools to Mitigate Risk

Despite the increasing responsibilities of directors and the potential risks they face, directors have many tools at their disposal to protect themselves from personal liability for board decisions. The first line of defense for a director is usually found in the company's articles of incorporation and bylaws. In Delaware, for example, corporations are allowed to include exculpatory clauses in their charters. Exculpatory clauses absolve directors from liability for alleged breach of the fiduciary duty of care, which is an obligation to act on an informed basis. The clause applies when a director's decision was in good faith, did not involve intentional misconduct, and was not a knowing violation of law. When corporate charters include exculpatory clauses, directors can ask courts to dismiss a derivative lawsuit at its outset. So these clauses provide a powerful tool to insulate directors from lawsuits second-guessing a board's decision-making process. However, exculpatory clauses do not provide any protection when directors allegedly violate their fiduciary duty of loyalty to the company.

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Directors should also ensure that corporate charters and bylaws provide the broadest indemnification rights permitted by law. Lawsuits and regulatory investigations can result in significant defense costs, and indemnification clauses typically require a company to advance on a current basis fees and costs incurred by directors for most lawsuits and investigations. In Delaware, corporations are allowed to indemnify a director if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation. Indemnification even extends to a criminal action or proceeding if the director had no reasonable cause to believe his conduct was unlawful.

Courts often apply a deferential standard—the business judgment rule—when considering derivative actions challenging board decisions. Courts apply this standard in certain circumstances so the court is not substituting its judgment for that of the directors tasked with doing so. The business judgment rule insulates directors from liability when they are not interested in the subject of the business decision, are informed to the extent reasonably necessary, and determine that the decision is in the best interest of the corporation. The rule does not insulate a director who has a conflict of interest in a board decision such that the director's duty of loyalty to the company is implicated.

The business judgment rule can offer substantial protection when a director can show adherence to good process. And good process will deter lawsuits and allow for early disposition of derivative suits when they are brought. To ensure decisions are afforded the protection of the business judgment rule, directors can follow best practices to demonstrate the good process for decision making. First, directors must ensure that they are independent of company management, large investors and others affected by board decisions so that they can exercise their judgment without the appearance of a conflict.

Second, when one or more directors have a potential conflict, the board must take steps to ensure true independence of decision making on conflicted issues. For example, when a large shareholder who has appointed several directors to the board makes a tender offer to purchase the remaining shares of the company, the board should demand the creation of a special committee of directors, unaffiliated with the investor, to evaluate and make recommendations regarding the tender offer. The special committee can then make a disinterested decision, without the involvement of directors affiliated with the potential purchaser.

Third, boards can protect themselves from liability by hiring high-quality outside consultants to advise the board. In the case of a tender offer, the board should hire financial advisors and lawyers to assist the board with considering the tender offer and ensuring that the process for considering the tender offer is fair and produces the best result for shareholders. Directors may also decide to retain outside legal counsel to investigate a corporate securities or compliance issue before a regulatory investigation or enforcement proceeding is commenced.

Directors of publicly traded companies have increasing responsibilities and face emerging challenges requiring attention and oversight. Directors must have procedures in place to recognize these risks and establish protocols for overseeing management's role in managing the risk. Claims professionals and defense counsel will rely on board documentation of procedures, a thorough review of regulatory compliance reports and solid recordkeeping concerning mergers and acquisitions, other financial decisions and shareholder disclosures.

Claims counsel should keep their nose in the air to sniff out what else plaintiff's lawyers are cooking up in the kitchen, because nobody likes surprises in the directors and officers world. ■

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