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D&Os BEWARE: BUSINESS JUDGMENT RULE UNDER ATTACK

The business judgment rule (BJR) has served for decades as the single most important protection against personal liability for directors and officers. First developed by courts over a century ago, this common law defense prevents courts from second-guessing the quality of a business decision by directors and officers. The two primary underpinnings of the BJR are:

1. Courts should not substitute their inexperienced business decisions for the good-faith decisions of independent and diligent business executives, who have a far greater ability to make appropriate business decisions based on their extensive commercial knowledge, experience and training.

2. Executives should be encouraged to take prudent risks for the benefit of the company and its constituents, and should not be stymied by the fear of personal liability if a decision ultimately harms the company.

The BJR generally applies to business decisions made by disinterested and reasonably informed directors and officers who honestly and rationally believe their decision was in the best interest of the company. If the BJR applies, directors and officers should not be liable for the quality or results of their decisions, but only the process used to make the decision.

As summarized below, several recent cases demonstrate this important defense for directors and officers is not full proof, and suggest some courts may be adopting a disturbing trend toward diluting the benefit of the BJR. At a minimum, these cases highlight the volatile liability exposure which directors and officers face despite the BJR and the need for strong D&O financial protections to address that exposure.

A. BJR Inapplicable to Officers

Most courts and commentators have assumed without much discussion or analysis that the BJR rule applies to both directors and officers. But, two recent decisions by federal district courts in California ruled that the BJR applies only to independent directors, not officers.

In *FDIC v. Perry*, 2011 U.S. Dist. LEXIS 143222 (C.D. Cal., Dec. 13, 2011), the FDIC alleged that the CEO of IndyMac Bank breached his fiduciary duties to the failed bank by allowing IndyMac to generate and acquire more than $10 billion in risky residential loans, resulting in more than $600 million in losses to the bank. The CEO argued the lawsuit should be dismissed based on the BJR. The Court ruled that under California law, both the common law and statutory BJR applied only to directors, not officers, and therefore the Court refused to dismiss the lawsuit.

With respect to the common law BJR, the Court found no prior decision in California which applied the BJR to officers. The Court noted one California case which held the BJR did

not apply to "interested directors who effectively were acting as officers," although the inapplicability of the BJR in that prior case could be explained by the directors' "interested" status rather than the directors' de facto officer status. Without explanation, the Court rejected the notion that the general judicial policy of deference to business decisions shall apply to officers, which is obviously disturbing since courts are generally ill-equipped to substitute their business decisions (using the benefit of 20/20 hindsight) for the real-time business decisions of executives.

With respect to the California statutory BJR, the Court observed that the statute provides that directors who perform their duties as directors in accordance with the statutory standards have no liability for failing to properly discharge their duties as such. The statute, though, does not mention officers. In explaining the statute's omission of officers, the Court cited to the legislative committee's comments to the statute, which seems to acknowledge that officers were intentionally excluded from the statute for the following reason:

> Although a non-director officer may have a duty of care similar to that of a director, his ability to rely on factual information, reports or statements may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation.

In an unreported August 1, 2011 ruling in *National Credit Union Administration v. Siravo*, Case No. CV-10-01597 (C.D. Cal.), a different Federal District Court judge in California also ruled that the BJR did not apply to officers, based on the plain language of the California statutory BJR which applies only to directors.

One can certainly debate the wisdom of excluding officers from the BJR. Even though officers are more knowledgeable and involved in the company's operations than independent directors, the underlying justifications for the BJR (i.e., courts are ill-equipped to second-guess business decisions and should encourage prudent risk-taking) equally apply to claims against directors and officers.

Whether these California decisions are followed by other courts in California or in other states is yet to be seen, but it reflects the potential for a disturbing judicial abandonment of an important protection for officers.

B. BJR Inapplicable to Intimidated Directors

One of the key elements of the BJR is the requirement that the defendant director or officer must be disinterested (i.e., the business decision must be based on the corporate merits of the decision rather than extraneous considerations or influences). Courts most frequently find this requirement lacking, and thus the BJR inapplicable, where the director or officer has a conflict of interest with respect to the decision, such as a personal financial interest in the decision or a close familial or business relationship which may impact the decision.

A recent Delaware Chancery Court decision ruled that otherwise disinterested directors may be considered "interested" and thus lose the BJR protection by allowing another "interested" director to intimidate them into making a particular decision.

In *New Jersey Carpenters Pension Fund v. Info GROUP, Inc.*, 2011 Del. Ch. LEXIS 147 (Del. Ch., Sept. 30, 2011), a director who owned 37% of the company's outstanding stock encountered a personal cash liquidity crisis and concluded that the best option to address that liquidity crisis was to promptly sell the company, regardless of whether the timing, price or process of the company sale was in the best interests of the company. The director lobbied the other directors to pursue a sale even though the rest of the Board (consistent with the advice of an investment banker) believed the market conditions would make it difficult to obtain a good price for the company.

The conflicted director intensified his efforts to bring about a sale of the company by repeatedly threatening other directors with lawsuits if they failed to sell the company, being generally disruptive at board meetings and waging a public campaign to fire the CEO. Eventually, the Board was "overwhelmed" by the conflicted director and pursued a sale of the company. As explained in an email from one director to another, the majority of the directors apparently "just want to dump the company and run…based on the pain, trauma, time, and everything else." The conflicted director continued to disrupt the sale process by influencing the list of potential bidders, conducting unsupervised negotiations and leaking confidential information about the sale to various parties. Ultimately, the Board accepted an offer to purchase the company at a price per share below the then current market price.

In addition to finding the BJR inapplicable to the conflicted director, the Court refused to dismiss the claims against the other directors based on the BJR because "it is reasonable to infer that [the conflicted director] dominated the Board Defendants through a pattern of threats aimed at intimidating them, thus rendering them non-independent for purposes of [applying the BJR to their] voting on the Merger."

Although the extreme facts of this case may explain the Court's ruling, the notion that directors may lose their BJR protection by reason of a dominating or intimidating director or control person is disconcerting. The line between frank discussions/disagreements and intimidation/domination can become blurred. When dissenting views or disagreements arise, the Board should be extra cautious to create a clear and credible record that whatever decision is ultimately made is supported by legitimate and compelling business reasons and is not influenced by extraneous considerations.

C. <u>BJR Inapplicable to Uninformed Directors</u>

Another key element of the BJR is the requirement that the defendant directors and officers make an informed decision by conducting a reasonably diligent investigation before acting. Typically, this requirement is satisfied if the directors spend considerable time in making the decision and obtain advice from qualified experts. However, a recent federal Third Circuit Court of Appeals ruling reversed the dismissal of claims against directors of a bankrupt non-profit company based on the BJR even though the defendant directors received the advice of

counsel, conducted several meetings and pursued various options before making the challenged decision to file for bankruptcy protection.

In *Official Committee of Unsecured Creditors v. Baldwin*, 2011 U.S. App. LEXIS 19312 (3d Cir., Sept. 21, 2011), the Court of Appeals ruled that the District Court improperly granted a motion for summary judgment in favor of the defendant directors based on the BJR, notwithstanding the directors' apparent diligence. The Court of Appeals ruled that plaintiffs presented credible evidence that the Board (i) received numerous red flags that senior officers upon whom the Board relied in making its decision were neither competent nor diligent, (ii) eschewed a viability study prior to filing bankruptcy, and (iii) diverted assets to another charitable organization which had an interlocking Board with the bankrupt company. As a result, triable issues of fact existed which precluded summary judgment in favor of the defendant directors.

This decision demonstrates that all aspects of a Board's decision should be reasonable and thorough. Although it is unusual for a court to second-guess the adequacy of the directors' diligence, if any part of the decision-making process is less than robust, the BJR may not be available even if all other aspects of the decision-making process are proper.

D. Circumvent BJR

A more subtle way plaintiffs are now avoiding the applicability of the BJR is by bringing traditional D&O mismanagement claims as federal securities law claims. The BJR only applies to common law breach of fiduciary claims (which are usually asserted in shareholder derivative lawsuits), and does not apply to federal securities law claims (which are usually asserted in securities class action lawsuits).

Historically, plaintiffs have had little ability to remedy D&O mismanagement through a securities law claim. In 1977, the U.S. Supreme Court ruled that a federal securities law claim must be based upon deceptive conduct (i.e., misrepresentations and omissions of material facts), rather than on allegations of mismanagement. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). For more than 30 years, that ruling effectively eliminated attempts by the plaintiffs' bar to circumvent the BJR through the assertion of mismanagement claims in the guise of a securities claim.

However, more recently plaintiffs are again testing the bounds of what is mismanagement and what is deceptive misconduct. In the aftermath of several high-profile incidents of sudden and accidental events (e.g., explosions, coal mine collapses and natural disasters), plaintiffs have tried to assert a securities class action in lieu of or in addition to a derivative lawsuit for mismanagement. If successful, this strategy both circumvents the powerful BJR defense and creates the potential for recovery of huge damages to a large class of shareholders.

An example of this strategy is the D&O litigation arising out of the 2010 Gulf of Mexico oil spill. Although the Deepwater Horizon rig explosion and resulting oil spill was sudden and unexpected, securities class actions were filed against the directors and officers of British Petroleum (BP), alleging that prior to the explosion and spill the defendants misrepresented and failed to disclose information regarding the adequacy of BP's safety programs and BP's resulting

risk exposure. The defendant D&Os argued to the Court, among other things, that the securities claims should be dismissed because the true nature of the alleged wrongdoing was merely mismanagement. With surprising ease and with little analysis, the Court rejected the defendants' argument, noting that the plaintiffs alleged the defendants launched an ongoing public relations campaign before the Deepwater Horizon incident to improve BP's safety image with investors and that the subsequent alleged safety misrepresentations were not limited to the Deepwater Horizon catastrophe. *In re BP p.l.c. Securities Lit.*, 758 F. Supp. 2d 428 (S.D. Tex., Feb. 13, 2012).

The line articulated by the Court between mismanagement (which is subject to the BJR) and deception (which is not subject to the BJR) appears very thin. Under the reasoning of this decision, in almost any situation involving alleged mismanagement, plaintiffs will likely be able to also successfully allege a securities claim based on deception. In other words, as a result of this and several other similar recent decisions, creative plaintiffs are more likely now to circumvent the protections of the BJR by converting a mismanagement claim into a securities law claim. If other courts also allow this litigation strategy, directors and officers will be facing an increasing number of securities claims arising out of unexpected events which harm the company and its shareholders.

E. Fewer Inexpensive Derivative Settlements

In response to the strong protection afforded by the BJR, shareholder derivative lawsuits are frequently settled by (i) the company agreeing to certain governance reforms and other corporate "therapeutics," and (ii) the defendant directors and officers (through their insurers) agreeing to pay a modest plaintiff attorney fee award. Although this type of settlement structure creates questionable benefit to the company and primarily benefits only the plaintiff attorneys, the fee payment by the D&O insurer can be justified in many cases in light of the potentially large defense costs which would be incurred absent the modest settlement.

The continued viability of this common settlement practice may be questionable in some jurisdictions in light of recent case law which refused to approve this type of settlement arrangement. For example, in one case the Court refused to approve a $2.85 million plaintiff fee award in a derivative suit settlement involving only corporate reforms. The Court found the corporate reforms to be "cosmetic" and "far too meager" in light of the alleged wrongdoing. To justify these reforms, plaintiffs' counsel argued at the settlement approval hearing that after substantial discovery the plaintiffs are unable to prove the alleged wrongdoing. In a colorful summary of why the proposed plaintiff fee was rejected, the Court stated:

> By approving this Stipulation of Settlement, the Court would be compensating Plaintiffs' counsel handsomely and encouraging plaintiffs' attorneys in the future to go on fishing expeditions against corporations. Sometimes when an attorney goes fishing he catches a fish, and sometimes he does not – but when he does not, he should not eat filet mignon afterwards.

In re Cirrus Logic, Inc., 2009 U.S. Dist. LEXIS 131583 (W.D. Tex., Jan. 8, 2009).

In another recent case, plaintiffs dismissed their derivative lawsuit because the company's Board took certain actions requested by the plaintiffs in their lawsuits. Plaintiffs' counsel requested a fee award from the Court because they contended their derivative lawsuit was the catalyst for the Board's actions. The defendants disagreed, contending the Board's actions were taken independent of the derivative lawsuit. The Court found the derivative lawsuit was meritless and would have been dismissed by the Court if plaintiffs had not voluntarily dismissed it. As a result, the Court refused to award any fees to plaintiffs' counsel. *Central Laborers' Pension Fund v. Blankfein*, 2011 N.Y. Misc. LEXIS 4555 (Sup. Ct. NY, Sept. 21, 2011).

These cases suggest the ability to settle derivative suits by agreeing to corporate reforms and a plaintiff attorney fee payment may be increasingly limited in certain situations. That may result in plaintiffs litigating derivative suits longer, more aggressively attacking the BJR and insisting on a monetary component to the settlement in order to show greater benefit to the company and thus a larger plaintiff fee award. In other words, these seemingly pro-defendant rulings may ironically increase the erosion of the BJR and the defendants' loss payments in future derivative suits.

F. Insurance Considerations

As the BJR protection fades, the liability exposure of directors and offices in shareholder derivative lawsuits increases. This is particularly troubling for the defendant directors and officers since in most states a company cannot indemnify its directors and officers for settlement or judgments in derivative lawsuits. Instead, the company's D&O insurance program is the sole source of financial protection for directors and officers in derivative litigation.

As a result, it is more important than ever that a company maintain the highest quality D&O insurance program possible. In particular, a company should maintain a comprehensive Side A D&O insurance, which affords extraordinarily broad coverage for non-indemnified losses, subject to a limit of liability that cannot be eroded by losses incurred by the company.

Companies are required under those Side A policies to indemnify their directors and officers to the fullest extent permitted by law. That indemnification obligation by the company is generally covered under the standard "ABC" D&O policies which underlie the Side A policies in a company's D&O insurance program. To preserve the Side A limits of liability, a derivative suit settlement can be structured such that the defendants pay the plaintiffs' attorney fees separate from any settlement payment. Under that type of settlement structure, the plaintiff fee award should be indemnifiable by the company even though the base settlement amount is non-indemnifiable by the company. For example, instead of agreeing to a $10 million derivative settlement out of which the plaintiffs' $2 million fee award is paid, the parties could agree to an $8 million settlement plus a separate $2 million plaintiff fee award. That separate fee award should be indemnifiable by the company (and covered under the company's "ABC" D&O policies), thus preserving an additional $2 million of the Side A limits of liability.

G. Conclusions

The recent erosion by some courts of the BJR may be a reaction, in part, to the current economic environment and a sense that someone should be held responsible for causing or contributing to the credit crisis and related Great Recession. However, as explained by the Delaware Chancery Court in a recent derivative lawsuit against directors and officers of Citigroup relating to their alleged involvement in the subprime mortgage collapse, the justifications for the BJR equally apply regardless of the size of the losses in the derivative lawsuit or other external circumstances:

> Citigroup has suffered staggering losses, in part, as a result of the recent problems in the United States economy, particularly those in the subprime mortgage market. It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.

The apparent erosion of the BJR by some courts is inconsistent with the foregoing judicial comments and, if continued, will significantly increase the liability exposure of directors, officers and their insurers.