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CORPORATE LITIGATION WEBSERIES

The Changing Landscape of Director & Officer Liability

Victoria Tidwell
Vice President, Legal Affairs
Cypress Semiconductor Corporation

Richard Morvillo
Partner
Mayer Brown LLP

Lee Rubin
Partner
Mayer Brown LLP

Fabio Bertoni
Deputy General Counsel
Incisive Media

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Potential for Litigation

- Federal/State securities fraud suits brought by shareholders/investors

- Derivative suits by shareholders alleging breach of duty of care or duty of loyalty

Basic Fiduciary Duties: Care and Loyalty

- Fiduciary Duties under Delaware law (*Stone v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006))
  - Duty of Care – breach is "gross negligence"
  - Duty of Loyalty – breach is a "financial or other cognizable fiduciary conflict of interest," or "where the fiduciary fails to act in good faith"
- Delaware Supreme Court recently clarified that the duty of good faith is part of the duty of loyalty: "The failure to act in good faith may result in liability because the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty." *Id*. at 369-70.

Duty of good faith

- Three categories of conduct that "are candidates for the 'bad faith' pejorative label" (*In re Walt Disney Co. Derivative Litig*., 906 A.2d 27, 64 (Del. 2006)):
  - "'[S]ubjective bad faith,' that is, fiduciary conduct motivated by an actual intent to do harm" – This is "classic, quintessential bad faith." *Id*.
  - "[L]ack of due care -- that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent" – This conduct, standing alone, is not bad faith. *Id*. at 65.
  - Between the above two categories is "intentional dereliction of duty [or] a conscious disregard for one's responsibilities." Delaware Supreme Court recognized this conduct as lack of good faith constituting breach of duty of loyalty. *Id*. at 66-67.

Fiduciary Duty of Oversight

- Also not an independent duty, but derives from duty of loyalty.
- "*Caremark* [*In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996)] articulates the necessary conditions predicate for director oversight liability:
  - (a) the directors utterly failed to implement any reporting or information system or controls; or
  - (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."

  Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).
- "In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." Touchstone of breach is "conscious disregard for their responsibilities."

Fiduciary Duty of Disclosure

- "The duty of disclosure is not an independent duty, but derives from the duties of care and loyalty." *Pfeffer v. Redstone*, 965 A.2d 676, 684 (Del. 2009) (citations and quotations omitted)
  - Critical when seeking shareholder approval for particular action.
  - Disclosure of all material terms of transaction
  - Disclosure of any conflicts/relationship
- "Corporate fiduciaries can breach their duty of disclosure under Delaware law ... by making a materially false statement, by omitting a material fact, or by making a partial disclosure that is materially misleading." *Id*.
  - "Material facts are those facts for which there is a substantial likelihood that a reasonable person would consider them important in deciding how to vote." *Id*.

Fiduciary Duties Are the Same for Officers and Directors

- "[O]fficers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and [] the fiduciary duties of officers are the same as those of directors." *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009).

Exculpatory Clauses Provide Only Limited Protection

- DGCL 102(b)(7) permits a company to include in its charter "a provision eliminating … the personal liability of a director . . . for breach of fiduciary duty . . . provided that such provision shall not eliminate . . . liability . . . for acts or omissions not in good faith"
- Claims of breach of duty of loyalty not covered. Allegations of bad faith – "intentional dereliction of duty [or] a conscious disregard for one's responsibilities" -- may permit plaintiff to do an end run around the exculpatory provisions of DGCL 102(b)(7).
- "Although legislatively permissible, currently no statutory provision authorizing comparable exculpation of corporate officers."
- There may be good policy reasons for not exculpating corporate officers for breach of the duty of care.

Specific Application: Merger/Acquisition

- *Lyondell Chemical Co v. Ryan*, 2009 WL 1024764 (Del. Apr. 16, 2009): Class action lawsuit challenging that directors breached their fiduciary duties during the $13 billion sale of company.
- Under *Revlon v. MacAndrews & Forbes Holdings, Inc*., 506 A.2d 173, 182 (Del. 1986) -- part of directors' existing fiduciary duties is to take steps to maximize the sale price of the company. Lower court had found that directors liable for not confirming that they had obtained the best price by conducting an auction, conducting a market check, or demonstrating "an impeccable knowledge of the market." *Id.* at *6. The Delaware Supreme Court reversed:
- "Directors' decisions must be reasonable, not perfect." *Id.* at *7.
- "Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the trial court's inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price." *Id.*
- The Supreme Court found that the directors did not breach their duty of loyalty (*id*.):
  - "met several times to consider [the acquirer's] premium offer"
  - Were "generally aware" of the value of their company and the market
  - "solicited and followed the advice of their financial and legal advisors"
  - "attempted to negotiate a higher offer even though all the evidence indicates that [the offer was] a 'blowout' price"
  - "approved the merger agreement, because 'it was simply too good not to pass along [to the stockholders] for their consideration.'"

Specific Application: Possible Liability for Officer, But Not Directors

- *McPadden v. Sidhu*, 964 A.2d 1262 (Del Ch. 2008):
- Trial court found that plaintiffs had adequately alleged that the directors and an officer of i2 Technologies were grossly negligent in the sale of Trade Services Corporation ("TSC"), a wholly owned subsidiary, for $3 million.
- In carrying out the sale, the officer contacted only three potential buyers, none of which were competitors of TSC. The officer did not contact companies which had previously offered to pay $25 million for TSC. In addition, the officer was the principal owner of the acquiring company that paid only $3 million, and this acquiring company sold TSC two years later for $25 million.
- Gross negligence is "conduct that constitutes reckless indifference or actions that are without the bounds of reason." *Id.* at 1274.
- The court found i2's directors grossly negligent in overseeing the officer's sale of TSC. The board's gross negligence breached their duty of care, but an exculpatory provision in i2's certificate of incorporation protected the board from liability. (The court found that the plaintiffs had not demonstrated that the board consciously disregarded their duties, as required for bad faith). *Id.* at 1274-75.
- Officers cannot be protected by exculpatory provisions. Thus, the court held that plaintiffs could maintain their action against the officer who coordinated the sale, for breach of his duty of care. *Id.* at 1275-76.

Specific Application: Options Backdating

- The Delaware Chancery Court, in two 2007 cases, refused to dismiss complaints alleging inappropriate manipulation of options.
- *Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007):
  - Complaint adequately alleged bad faith conduct by directors where facts alleged "the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan." *Id.* at 358.
- *In re Tyson Foods*, 919 A.2d 563 (Del. Ch. 2007):
  - Court denied motion to dismiss Compensation Committee directors in springloading case, noting that "[i]t is difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at 'market rate' and simultaneously withhold that both the fiduciary and the recipient *knew* at the time that those options would quickly be worth much more." *Id.* at 590-91 (emphasis in original).

Indemnification Issues

- A finding of bad faith has the collateral consequence that no indemnification, including for legal expenses, of the director is permitted.

- DGCL 145(a) provides that a corporation shall have the power to indemnify only "if the person acted in good faith."

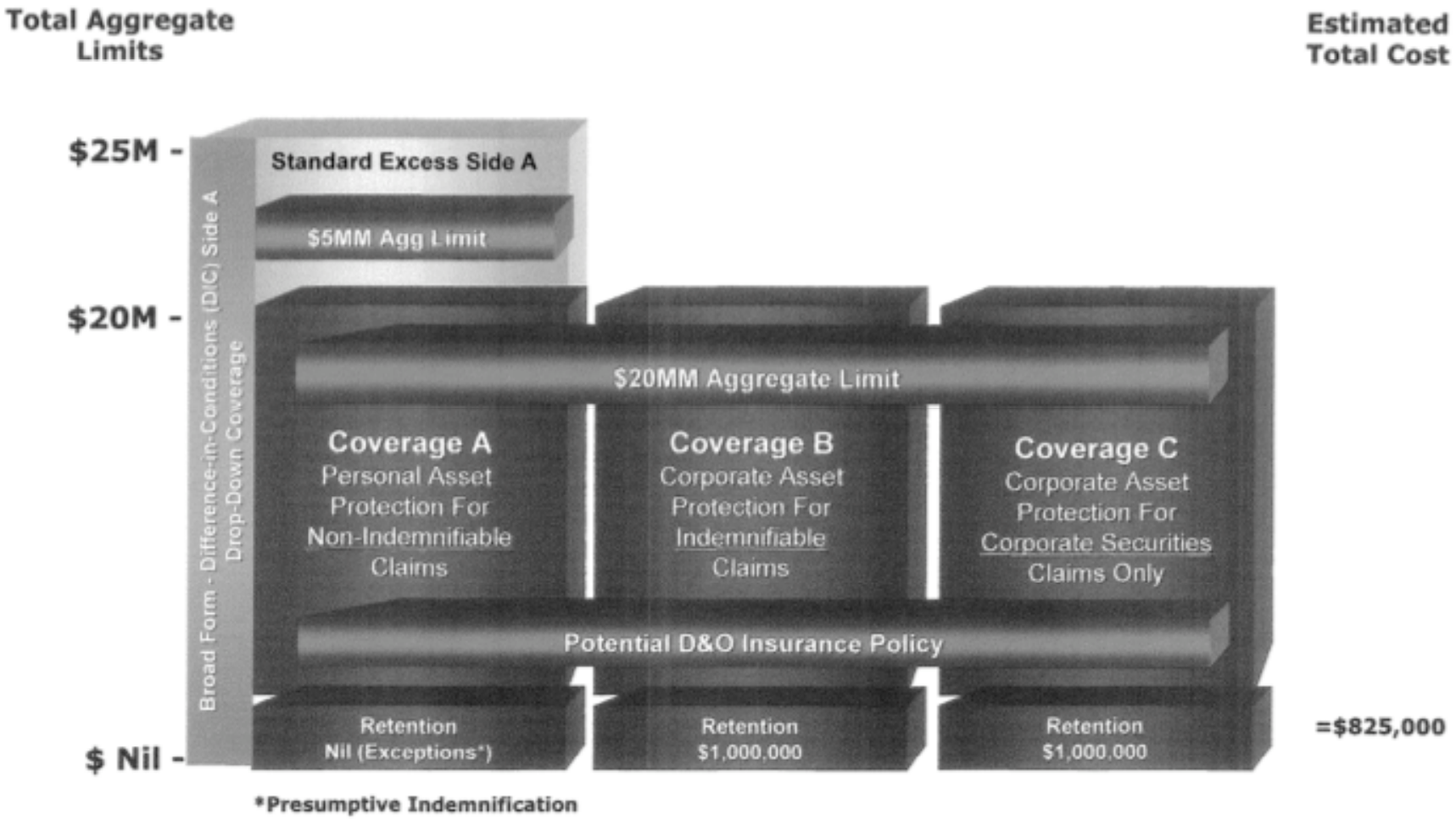
Recent Cases on Indemnification

- *Schoon v. Troy Corp.*, 948 A.2d 1157 (Del. Ch. 2008):
  - Delaware Chancery Court upheld amendments to the bylaws of a corporation that retroactively eliminated a former director's right to receive advancement of expenses in cases filed after the former director left the board, even for conduct that pre-dated the amendments.
  - One possible way to avoid this result might be to provide for indemnification rights in a separate contract with the director.
- *Levy v. HLI Operating Co., Inc.*, 924 A.2d 210 (Del. Ch. 2007):
  - Delaware Chancery Court held that a director is not entitled to payment of his or her fees and expenses incurred while pursuing an indemnification claim against the corporation if the outcome of the suit is unsuccessful, even if the corporation had provided such benefit to the directors in their indemnification agreement.
  - In addition, once a director has been indemnified by a third party, such as a private equity fund, the director cannot seek indemnification from the company on behalf of such third party seeking reimbursement. Rather, the third party may pursue a contribution claim against the company.

Protecting Yourself

- Important Principles To Limit Exposure
  - Board should be sufficiently familiar with critical functions (i.e. financial statement preparation; interface with regulatory bodies) to leave no room for claim of recklessness/gross inattention.
  - Document Board meetings/review process.
  - Don’t be stingy in creating robust financial controls; one of greatest risk area.
  - Disclose all significant relationships/conflicts when seeking shareholder approval.

Sample D&O Insurance Structure



D&O Insurance – Menu of Options

- A/B/C side coverage
- Third party insurers or self-insured?
- What Riders do you Need? Want?
  - Rescission
  - "Capacity" Issues/Coverage for GCs
  - Entity Coverage/Shared Limits
  - "Hammer" Clause
  - Insured vs. Insured Exclusion
  - Coverage for Investigations
  - Tail Coverage
  - Punitive Damages
  - Fraud Exclusion

A Few Inconvenient Truths

- People break the law; companies don't
- Deterrence requires pursuing culpable individuals
- Mistakes don't always look like mistakes in hindsight
- If you benefited in some way, the government will think it can establish motive
- The best time to seek advice is before you do something you may later regret

Recent Enforcement Actions Involving Financial Fraud

SEC v. Kelly - Lit. Rel. No. 20586 (May 19, 2008):

- The SEC filed civil fraud charges against eight former officers of AOL Time Warner for their roles in a fraudulent scheme that resulted in the company overstating its advertising revenue by more than $1 billion.
- Four of the defendants have settled the charges in return for payments totaling over $8 million.

SEC v. Black - Lit. Rel. Nos. 20510 (Mar. 25, 2008) & 20043 (Mar. 16, 2007):

- F. David Radler, the former Deputy Chairman and COO of Hollinger International, Inc., the controlling shareholder of Sun-Times Media Group, Inc., was charged with violations of the antifraud, reporting, books and records, and proxy provisions of the securities laws. The SEC's complaint alleged that he diverted to himself $85 million in proceeds from newspaper sales through a series of related party transactions.
- Under the settlement reached with the SEC, Radler agreed to pay $28 million and to be barred from serving as a director or officer of a public company.

Recent Enforcement Actions Involving Financial Fraud (continued)

SEC v. Koenig - Lit. Rel. No. 20420 (Jan. 3, 2008):

- A jury in federal court in Illinois found that the former CFO of Waste Management, Inc., committed 60 securities laws violations in a 5-year period, including overstating the company's profits, falsifying books and records, and lying to auditors.
- The judgment entered by the court requires the former executive to pay over $4 million and bars him from acting as a director or officer of a public company.

SEC v. American Italian Pasta Co. - Lit. Rel. No. 20715 (Sept. 15, 2008):

- The SEC alleged that four officers engaged in a fraudulent scheme to inflate the company's earnings.
- Two of the four officers settled for payments totaling over $1 million. In addition, one of the two settling officers agreed not to serve as an officer or director of a public company.

Recent Enforcement Actions Involving Stock Option Backdating

SEC v. Analog Devices, Inc. - Lit. Rel. No. 20604 (May 30, 2008):

- The SEC alleged that the company's CEO reported false compensation to investors by backdating stock option grants to officers and directors.
- The CEO settled the charges for nearly $1.5 million in payments.

SEC v. Heinen - Lit. Rel. No. 20086 (Apr. 24, 2007):

- The SEC filed charges alleging improper stock backdating by Apple's former General Counsel and former Chief Financial Officer.
- The two officers settled the charges for over $6 million in combined payments.

Recent Enforcement Actions Involving Insider Trading

SEC v. Pai - Lit. Rel. No. 20658 (July 29, 2008):

- The SEC alleged that Lou Pai, the former Chairman and CEO of Enron Energy Services, Inc., a division of Enron Corp., sold Enron stock on the basis of material, nonpublic information.
- The settlement barred Pai from acting as an officer or director of a public company for five years. Pai also agreed to payments of over $30 million.

SEC v. Wong - Lit. Rel. No. 20447 (Feb. 5, 2008):

- The SEC alleged that a former Dow Jones & Company board member engaged in illegal tipping and insider trading ahead of an unsolicited buyout offer from News Corporation in 2007.
- The board member agreed to pay a penalty of over $8 million.

Enforcement Powers

- What the SEC can do
  - An administrative or injunctive action
  - Disgorgement of profits or benefits
  - Penalties
  - Officer and director bars
- Remember: Every knowing violation of the federal securities laws is a crime
- And the sentencing guidelines are harsh

Common Pitfalls

- Beware of transactions that have unusual features:
  - Not properly documented
  - Side letters
  - Quarter or year end revenue-producing transactions
  - Round trips and multi-pronged transactions
  - Approvals after-the-fact

Common Pitfalls (continued)

- Unusual revenue recognition
  - They are your financial statements
  - What do the auditors say?
- Be careful with non-public information
  - Tipper/tippee liability
  - A system to detect and prevent
- Develop and follow good internal controls
- Be careful with emails
- Understand the disclosure regime
- If you see something funny, don't let it go

Common Pitfalls (continued)

- Investigate suspicious conduct
  - To self-report or not to self-report
- Parallel proceedings
  - Representational issues
  - Ethical traps

Contact

Richard Morvillo

Mayer Brown LLP

+1 202 263 3290

rmorvillo@mayerbrown.com

Lee Rubin

Mayer Brown LLP

+1 650 331 2037

lrubin@mayerbrown.com