

Litigation

Shareholder Suits: You Ain't Seen Nothing Yet

By Walter Stuart and Jessica Mussallem

**ARTICLE APPEARED IN *CORPORATE BOARD MEMBER*,
JANUARY/FEBRUARY 2009**

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All the recent bankruptcies and bailouts mean that courts may be taking a much more critical look at whether directors have been satisfying their fiduciary duties to companies and shareholders. The fallout from the collapse of the subprime lending market has already resulted in hundreds of lawsuits and bankruptcy cases, as well as robust reaction by federal and state regulators. The Securities and Exchange Commission is investigating the roots of the crisis, including the adequacy of corporate disclosures. The FBI has launched the Subprime Mortgage Industry Fraud Initiative. State attorneys general have brought enforcement actions against companies and boards, alleging consumer fraud and other lending misconduct. Individual cities, notably foreclosure-racked Cleveland, are turning litigious too. There are also multiple joint task forces, one of which includes the FBI's new fraud unit, the U.S. Postal Inspection Service, the U.S. Secret Service, the New York State Banking Department, the New York City Department of Investigation, and the Federal Deposit Insurance Corp.

Directors are being blamed for almost everything that's gone wrong in the economy — from the subprime mortgage crisis to the federal bailout to excessive CEO pay. It looks as though the courts may not like board members either. Better check that D&O.

Almost all of the subprime-related securities lawsuits filed in 2008 include directors among the targets. Shareholders of Perini Corp., a Framingham, Massachusetts, general contractor, filed a class-action suit last August alleging that officers and directors had failed to disclose subprime-related risks and

difficulties the company was experiencing. At MonyGram International, a similar suit alleged, among other things, that officers and directors had concealed the Minneapolis company's lack of requisite internal controls, which hid its exposure to uncollectible debt.

Courts seem disposed to hear these cases, as 11 directors of Countrywide Financial have found out. A federal district court in California told them they must answer shareholder accusations that they failed to monitor lending practices that brought about the mortgage lender's collapse. Rejecting the directors' argument that they were unaware of the loan operations that led to ballooning defaults, the court ruled that they could not be "blind to widespread deviations from the underwriting policies and standards being committed by employees at all levels" and ignore the "numerous red flags" that should have warned them of the increasingly risky loans being made.

Directors are required to fulfill two legal duties: the duty of care and the duty of loyalty. The former generally requires directors to exercise care in a manner reasonably believed to be in the best interests of the company. This comes into play in both a business-decision

context and an oversight context, requiring directors to make sure that systems are in place to provide the board with all necessary information to do its job and, of course, to make use of the systems by actively monitoring corporate programs and policies. The duty is now being invoked to blame directors for aspects of the subprime debacle — alleging, for example, that they failed to monitor lending practices, manage company finances, disclose the degree of exposure to risky credit vehicles, or properly represent the value of offerings.

The distinction between the two duties has significant practical effects, since most states allow companies to indemnify directors for breaching the duty of care but not loyalty. Until recently, the duty of loyalty was generally interpreted as merely requiring directors to refrain from engaging in self-dealing transactions. In 2006, however, the Delaware Supreme Court stated that a director's failure to act in good faith in his oversight role in fact breaches the duty of *loyalty* — and that the breach is not covered by exculpatory charter provisions.

Although the business-judgment rule allows courts to presume that directors were acting in good faith to further legitimate corporate purposes when making decisions, it does not cover situations where directors act in bad faith. A Delaware bankruptcy court upheld a duty-of-loyalty claim against the directors of Bridgeport Holdings Inc. (formerly Micro Warehouse) even though there were absolutely no allegations of self-dealing. The court found that seven of the eight board members (one was dismissed from the case because he had been a director for only a few days) had breached their duty of loyalty by failing to act in good faith and by disregarding their duties. Both claims would normally have fallen under the duty-of-care umbrella. The directors allegedly could have improved the financial performance of the company in a variety of ways but failed to follow through with any of them and instead led the company into further liquidity problems culminating in a rushed "fire sale" of its assets the day before it filed for bankruptcy. Specifically, the court found that a number of allegations against the directors could support a claim for breach of loyalty, namely that they failed to put the assets up for sale earlier and hire a turnaround expert and abdicated their responsibilities to the COO, failed to supervise him, and simply acquiesced to his advice to sell the assets quickly before filing for bankruptcy, rather than through a court-supervised auction. The ruling suggests that it could be highly problematic for a board to delegate its duties, even to a corporate officer.

Executive compensation also leaves directors with increasing legal exposure. The public's outrage over some CEO and other top-executive pay packages may mean the courts will begin to look more closely at directors' roles in approving them. Boards may have felt protected by the 2006 Delaware Supreme Court decision that the directors of Walt Disney Co. were not liable for failing to detect "the potential magnitude" of former CEO Michael Ovitz's severance package. But this is becoming a risky presumption. In October, the Treasury Department unveiled its attempt to rein in executive pay at companies taking advantage of the federal bailout. The same month, New York attorney general Andrew Cuomo vowed to recover bonuses and perks from executives at American International Group and made AIG promise not to dole out any more. He's also pushing banks that receive federal bailout money to disclose how much they pay their executives in bonuses and incentives.



Courts are taking a stand too. A Delaware court found that the board members of ICN Pharmaceuticals violated their duty of loyalty when they approved bonuses for themselves and executives without the advice of an independent committee, expert, or counsel. A New York bankruptcy court refused to accept Delphi Corp.'s reorganization plan unless the company agreed to slash \$87 million planned for executive bonuses. A Delaware court found that approving backdated options for executives in violation of a shareholder-approved stock-option plan was a breach of the directors' duty of good faith.

Now is the time for directors to reevaluate the various sources of insurance and indemnification that are available to them, and to use outside counsel if need be. The big mergers produced by the recent financial upheavals have already brought new wrinkles to directors' and officers' coverage — and new legal exposure. Delaware courts have held that merging companies can contractually agree to provide greater director protection than either outfit originally offered. Both the Bear Stearns-JPMorgan and the Countrywide Financial-Bank of America merger agreements include indemnification provisions for directors that are a lot more generous than previously.

With that, however, comes an unintended consequence. These improved indemnification clauses could lead to shareholder suits alleging that directors of the company being acquired breached their duty of loyalty by accepting a lower purchase price in order to obtain additional litigation protection.

There's no end to it.

For further information on this topic, please contact Partner [Walter Stuart](#) or V&E Associate [Jessica Mussallem](#), members of Vinson & Elkins' [Complex Commercial Litigation Practice Group](#). Visit our website to learn more about [Vinson & Elkins](#).

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