OUTSIDE DIRECTOR LIABILITY
A Summary

I – INTRODUCTION

Outside directors almost never incur actual liability for good faith conduct. The principal liability window of outside directors is under securities law, when the company is insolvent (and thus cannot indemnify directors), damages exceed the D&O insurance policy limits and the director is wealthy enough to be worth chasing but does not represent an institution that can indemnify him. The Sarbanes-Oxley Act does not alter this conclusion. Indeed, contrary to conventional wisdom, Sarbanes-Oxley is likely to reduce outside directors' exposure. 2

The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack. n5

Directors' risk under corporate law has not changed in the post Enron ear; and directors face a tiny risk of actual liability regardless of the source of law. 3

The paper does not deal with conflict-of-interest transactions or actions not taken in good faith.

The authors assume the companies limit director liability to the maximum extent legally possible (by charter and by law provbisions), but D&O, environmental and ERISA insurance with adequate coverage.

Inside directors are ones who are or were and officer, a controlling shareholder or a representative of a controlling shareholder. Outside directors are all others.

Inside directors also rarely face actual liabvility for good fiath conduct. Insiders, however, have far greater motive and opportunity to corss the line into bad faith conduct. 4

II - OUTSIDE DIRECTORS' ACTUAL LIABITLITY RISK

A – EVIDENCE AND SOURCES

We assume that a director can act in good faith (which largely means not having a personal financial interest in a transaction that he approves). Since 1991 there have been 2930 federal securities cases filed and 1557 such cases settled. Only one trial had outside director defendants and the defendants won that case.

B - CORPORATE LAW CLAIMS: DUTY OF CARE LIABILITY

Directors have <u>fiduciary duties</u> to the corporation and are potentially liable for breach of these duties. There are two basic fiduciary duties:

1) the <u>duty of care</u> (which includes the <u>duty of good faith</u> conduct) and
2) the <u>duty of loyalty</u>.

Directors also have a duty of disclosure and a duty of special care when one's company is a takeover target. Absent a conflict-of-interest, an outside director's failure to ensure proper disclosure is treated as a duty of care violation.

Law suits for breach of fiduciary duty can be either direct (brought by the shareholder against the director), or derivative (brought by a shareholder in the name of the corporation, with damages paid to the corporation). Directors face more risk in derivative suits (because indemnification is limited), but shareholders prefer direct actions when possible (because derivative suits face strong procedural hurdles). 8

1. *Business Judgment Rule and Section 102(b)(7)* – The duty of scare sounds scary. Directors must act "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. But Delaware has long limited director liability for breach of the duty of care through the lax standard by which compliance with this duty is measured – the business judgment rule. Under this rule, a director who is reasonably informed and acts in good faith is irrebuttable presumed to have satisfied the duty of care. The nominal standard for business judgment rule scrutiny is gross negligence in becoming informed. The de facto standard – outside the takeover context – is likely to be lower than this and catches only "directors who failed to pay any attention to corporate business." A sliver of duty-of-care exposure may remain if gross attention is severe enough for a court to find bad faith. 10

2. *Indemnification* – Indemnification plays two roles: 1. Directors may have to pay legal expenses to defend, even if not liable for damages. The suit could be for damages or injunction. Injunctions arise by a) a bidder in a takeover contest and b) others seeking remedies and attorney fees; and 2. If Section 102(b)(7) defense not available, to cover damages.

In the legal expense situation, a) the director may have to pay expenses in the first instance and b) he faces the risk of non-reimbursement. Indemnification and D&O coverage normally covere these.

Under Delaware Section 145(e), the corporation may advance expenses to defend a direct or derivative suit. The corporation may also 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." If a direct suit, both expenses and damage awards can be indemnified. If a derivative suit, only expenses can be indemnified.

3. *D&O Insurance* – Insurance plays the same roles as indemnification. The main differences are:
   a. D&O coverage remains available even if the firm is insolvent.
   b. It covers damage awards in derivative suits.
   c. It has a limit.

Note that policies often have no deductibles or copayment requirements. The generally exclude coverage for intentional mis-conduct and for duty of loyalty violations. 15

Current issues involving D&O insurance include:

a. Severability of coverage (one director acts in bad faith but the others do not)
b. Severability of application (are outsiders covered even though insiders falsified the application)
c. "Time gap" – a break in coverage
d. Complimentary coverage – other policies are expected to cover certain risks
e. Bankruptcy of the insurer, although coverage is usually layered and others will usually offer enough coverage

The bottom line for "duty of care" lawsuits, from a combination of indemnification and insurance: outside directors of public companies who act in good faith are *never* liable for either damages or legal expenses. 17

4. *Duty of Loyalty Claims (With No Loyalty Breach in Fact)*- In these cases, the claim is that the director breached his duty of loyalty but acted in good faith. Section 102(b)(7) does not apply, so damages are available. Plaintiffs prefer this kind of claim since damages are available.

Very few cases come up in this area. One instance is where a director has an interest in both companies to a transaction. The director can protect himself by abstaining from the decision-making at both companies. It would be unusual for a director to have a significant financial interest and not notice it.

The plaintiff will not claim bad faith because the plaintiff wants the benefit of the D&O insurance, which will go if bad faith is claimed. Once can imagine a derivative claim (and no indemnification) with facts strong enough to produce a settlement exceeding the D&O limits. But this is unlikely if good faith is present.

C – SECURITIES LAW CLAIMS

A typical class action claim would be that the company has caused investors to misprice its shares by (a) saying something material that is untrue or misleading, or (b) failing to say something important. Both are "mis-disclosure." Claims may be under the Securities Act or the Exchange Act. A director's liability is capped at 150% or his proportionate liability. 23

1. *Nominal Liability under the Securities Act and Exchange Act* – The company is strictly liable for mis-disclosure in the prospectus. The directors are also liable under the '33 Act but have a due diligence (non-negligence) defense. If the company is solvent, the plaintiffs have no reason to sue the outside directors.

Under the '34 Act, the company is liable if those responsible for the disclosure acted with scienter. Officers and directors with scienter are also liable. It is usually easier to prove scienter with respect to the inside directors since they have greater access to internal documents, e-mails, and other items that disclose the company's true position. If the company is solvent, the plaintiffs have little interest in the outside directors.

Litigation requires indications of scienter, often found by suspiscious trading prior to the offering. An outsider can avoid this inference by not selling whiel on the board, or selling on a pre-established schedule, with only a few shares for sale. Outside directors are more at risk for ’33 Act and ’34 Act claims. 25

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