Securities Class Actions and Derivative Litigation

Issues That Keep Corporate Counsel Awake at Night

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Recent trends in securities class actions and derivative litigation demonstrate that corporate counsel should take additional care to educate and advise board members and management about the risks in those cases and how to protect themselves from liability. While the number of filed securities class actions has decreased, the average cost of settling an action has doubled since the beginning of 2006. In addition, there have been a number of cases where portions of the settlement payments are being made by directors personally. Settlements in derivative actions, which traditionally required reforming corporate procedures and paying attorney fees, have, in recent cases, included substantial payments, some of which are being made by directors.

These trends suggest that corporate lawyers need to advise directors and officers accordingly. Lawyers should advise their board and management to take proactive steps such as staying informed about the trends and developments in those types of cases. They also should carefully monitor their corporation's compliance programs. Counsel also should keep directors and officers (D&O) aware of their company's indemnification agreements and D&O insurance coverage. If litigation does arise, the question of whether directors and officers need separate counsel should be fully discussed.

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Fewer Securities Class Actions . . .

As widely reported in the press, the number of securities class actions filed in 2006 declined from prior years. Many attribute this decrease to amendments to the federal securities laws. For example, the Private Litigation Securities Reform Act of 1995 significantly increased the pleading standards in federal class actions for plaintiffs, while the Securities Litigation Uniform Standards Act of 1998 prevented an "end run" around those standards to state court.

. . . with Increased Settlement Costs

While the number of cases has declined in recent years, the cost of settlements has increased. For example, in 2006 there were, for the first time, five class actions that were settled for more than $1 billion each. That trend seems to be continuing. For example, in May 2007, Tyco International, Ltd., reached a $3 billion settlement with its shareholders after lengthy mediation. The lawyers for Tyco described it as the largest class action settlement ever reached with a single corporation.

A national consulting firm, Cornerstone Research, recently released a study that revealed that the average amount of a settlement also has increased. For example, even when the $5 billion cases are set aside, the average settlement of a securities class action reached an all-time high of $45 million in 2006—more than twice the 2005 average.

Directors Paying for Settlements

Although class action settlements have traditionally been paid by the corporation and the D&O insurance carrier, there have been several recent settlements in which outside directors have personally paid a portion of the settlement. According to an article published by the *Stanford Law Review*, there have been 13 cases in the last 25 years in which directors have made out-of-pocket settlements to resolve securities class actions. Nine of those cases have been resolved since 2000.

Some have argued that these are exceptional cases and should not be of concern. Nonetheless, the *average* payment of each director in the Worldcom case (12 directors paying a total of $24.75 million) and the Enron case (10 directors contributing $13 million) is well over $1 million. An equally eye-opening statistic from the Worldcom case is that, because the D&O carriers' settlement contribution was only $36 million, the directors personally funded *over 40 percent* of the settlements in that case. If there is anything to be taken away from those cases, it is the unmistakable point that counsel needs to keep his or her board

aware that the cost of settlement in securities class actions is increasing and the personal cost to directors may increase as well.

An Increase in Derivative Actions . . .

Corporate counsel needs to follow the trends in recent derivative actions as well. Traditionally, the filing of a derivative action (a suit by a shareholder in the name of the company against directors and officers, typically charging a breach of fiduciary duty) infrequently followed the filing of a securities class action. In 2006, however, Cornerstone Research found that approximately 45 percent of the securities class actions had a "tag along" derivative suit, a significant change from prior years.

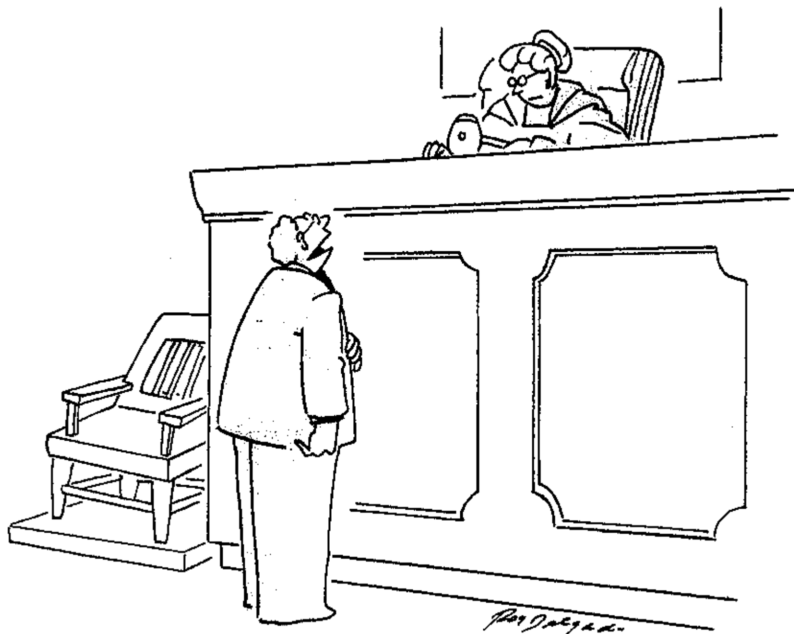
. . . with Increased Settlement Costs

Settlement trends in derivative suits also are changing. In the past, those cases frequently settled for a reform of corporate governance procedures and a payment of attorney fees. Recently, however, the settlement pattern has been changing, as reflected in the following examples:

- In February 2006, HealthSouth Corporation settled class actions and derivative litigation in Alabama for $445 million. To settle the claims against the company and its former directors and officers, HealthSouth agreed to contribute stock and warrants valued at $215 million, while the insurance carriers for the company agreed to pay $230 million in cash.
- In January 2006, Tenet Healthcare Corporation settled class actions and derivative litigation in California by agreeing to pay $215 million in cash. The company announced that the insurance carriers would contribute approximately $75 million toward the settlements—approximately $140 million was paid by the company.
- In May 2004, i2 Technologies, Inc., agreed to pay $84.85 million to settle class actions and derivative litigation in Texas.

The companies and the insurance carriers are not the only ones paying for the higher settlement costs. For example, in April 2007, five former outside directors of Just for Feet paid a total of $41.5 million to settle a bankruptcy trustee's state court breach of fiduciary duty suit. Just for Feet had previously declared bankruptcy and then settled a securities class action lawsuit (alleging accounting fraud) for $24.5 million. In 2001, the bankruptcy trustee for the company filed a claim in Alabama state court against the outside directors and the company's outside auditor, alleging conflicts of interest, misrepresentations, breach of fiduciary duty, and bad faith. Due to the prior class action settlement, only $100,000 remained available from the company's insurance, and, as a result, the former outside directors could not draw on the insurance when they agreed to the $41.5 million settlement.

Executives in other companies have made individual contributions to settlements, too. For example, when Oracle Corporation settled a derivative action in California in November 2005, its founder, Larry Ellison, agreed to make payment of $100 million to a charity. In the Tenet Healthcare litigation described above, two former executives paid a total of $1.5 million, while a total of $1.25 million was paid by individual defendants to settle litigation involving Weststar Energy, Inc., in April 2005.



"We're requesting a delay so my client can appear on lots of talk shows."

Steps for Corporate Counsel

What should corporate counsel do to help his or her board and management avoid these sorts of problems? No checklist is foolproof, but you should consider taking the following steps.

1. *Stay abreast of developments in class actions and derivative cases.* Look at it this way—the lawyers for plaintiffs are watching the trends and may assert the latest theory, argument, or strategy against your company. The developments described above—particularly the increasing costs of settlements and the fact that directors and officers have paid portions of the settlements—may be used as a benchmark in the next case.

The legal developments are also important—Supreme Court cases such as *Stoneridge Investment v. Scientific-Atlanta, Inc.* (scheduled to be heard and decided in the next Supreme Court term) may have a significant impact on who can be sued for securities fraud. On a practical level, the case will provide guidance in situations such as where a third-party vendor engages in a

business transaction with a public company that was structured by that company to facilitate a financial fraud.

2. *Remind your board to monitor the company's compliance programs.* Every company should have an existing compliance program—creating an awareness of commitment and standards, developing a risk assessment process, maintaining a monitoring program for misconduct, implementing a reporting system, and enforcing standards of conduct. You should discuss with your board whether to adopt written standards establishing the company's expectation that management and employees alike will act in accordance with laws, regulations, and applicable company policies. While maintaining a culture that promotes prevention, detection, and the swift resolution of potential violations of law or company policy does not prevent securities fraud claims, it can prevent potential problems and, when difficulties occur, aid in reaching a speedy resolution. In short, watchful vigilance is required.

3. *Review your indemnification agreements to assure proper coverage.* As New York District Court Judge Kaplan explained in the KPMG tax-shelter case, indemnification is a necessary part of corporate existence. Indeed, in his July 2007 decision, Judge Kaplan described how the government used the threat of prosecution against KPMG to strip individuals of their right to counsel:

> The government threatened to indict, and thus to destroy, the giant accounting firm, KPMG LLP ("KPMG"). It coerced KPMG to limit and then cut off its payment of the legal fees of KPMG employees. KPMG avoided indictment by yielding to government pressures. Many of its personnel did not. They now await trial, four of them deprived of counsel of their choice and most of the others unable to afford the defenses that they would have presented absent the government's interference.

The prosecutors denied the alleged conduct, but the court found otherwise:

> Having heard testimony from KPMG's general counsel, some of its outside lawyers, and government prosecutors, the Court concludes that the KPMG Defendants are right. KPMG refused to pay because the government held the proverbial gun to its head. Had that pressure not been brought to bear, KPMG would have paid these defendants' legal expenses.
>
> Those who commit crimes regardless of whether they wear white or blue collars must be brought to justice. The government, however, has let its zeal get in the way of its judgment. It has violated the Constitution it is sworn to defend.

While much of the media attention has focused on the judge's sharp criticism of the government, a valuable lesson for corporate counsel to take away from the case is the importance of the indemnification rights for directors and officers. Many outside directors would not consider taking such a position without that protection described by Judge Kaplan. Thus, while every company has indemnification and insurance, key questions that counsel will need to be prepared to discuss with directors and executives include: What is covered? What is not? Who will pay the defense costs?

4. *Carefully consider the company's D&O insurance.* As corporate counsel, you need to help the board fully understand the type of D&O coverage that exists. For example, it is important to determine if the coverage is long-term (locking your company into a price) or short-term. You also need to know what will happen if

Directors Are Paying More out of Their Own Pockets

Of the 13 cases identified by the *Stanford Law Review* article analyzing settlements impacting outside directors, 10 of them have resulted in payments since 2000:

- **$** twelve outside directors paid $24.75 million to settle 35 separate class actions regarding Worldcom, Inc., in 2005;
- **$** a group of directors and officers of Fuqua Industries paid a portion of $7 million in 2005;
- **$** a settlement in 2005 involving Lone Star Steakhouse resulted in a $54,000 payment, plus options repricing;
- **$** ten outside directors contributed $13 million to a $168 million settlement to settle a series of class actions against Enron, Inc., in 2004;
- **$** a group of 11 Enron directors contributed $1.5 million to settle a suit based on ERISA issues in 2003;
- **$** directors and officers from Independent Energy Holdings paid a portion of a $2 million settlement in 2003;
- **$** a payment of $22.5 million was made by one outside director to resolve SEC and criminal enforcement actions against Tyco in 2002;
- **$** several outside directors paid a total of $300,000 to $400,000 to settle a case in the last few years (the information was provided to the authors on a no-names basis);
- **$** a group of outside directors contributed something in the low millions around the year 2000 in a case that the authors said was provided on a confidential basis; and
- **$** a group of directors paid approximately $50,000 in a third confidential case around the year 2000.

Bernard Black, Brian Cheffins, and Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

the company's risk profile changes—will your insurer accommodate that risk?

The amount of coverage is obviously important, especially if the trend of increasing settlement costs continues. As discussed above, the five outside directors of Just for Feet learned the importance of that issue the hard way when they paid $41.5 million to settle a breach of fiduciary duty claim against them after discovering the company's settlement of a class action had exhausted all but $100,000 of the company's insurance coverage.

It is also important to understand who controls the process—the carrier or the insured—and other related questions. Who handles the claims process? What if there is a dispute between company and carrier? What happens during settlements—does the policy give the insurance company leverage to force a settlement by capping coverage if the company (or director or officer) does not agree to a settlement?

Another specific element of coverage to be reviewed is the question of severability. For example, if the insurance company seeks to rescind a policy because someone failed to disclose material facts, who loses coverage: the company, the individual responsible for the nondisclosure, or everyone? Similarly, many policies have a crime/fraud exception. To what type of conduct would exception apply? When can the insurer deny coverage—is it before the resolution of the case? Does the policy cover punitive damages?

Remember, insurance, like indemnification agreements, is there to protect the directors and officers. As counsel, you need to make sure they fully understand the extent of that protection.

5. *Consider whether directors and officers need separate counsel.* An internal investigation (or a government action) may be a precursor to a private action—the class action bar is watching not only the trends, but the cases, too. In many situations, a director or executive will believe the company's lawyers also are representing them individually as well. You, as corporate counsel, should identify those situations when the individual should retain his or her own counsel.

For example, when lawyers hired by the audit committee conducting an internal investigation call a board member or officer and say, "We just have a few questions . . .," those individuals need to know that the lawyers represent the audit committee and do *not* represent them individually. You also should advise them that what they say to those lawyers may not be privileged. When those lawyers communicate with the government or a regulator, they will act in the company's interest, which may not be in the best interest of individual directors or executives. Moreover, the plaintiffs' bar will be equally interested in that information if any class actions or derivative litigation follows those investigations.

If the matter has reached a stage that the company or the SEC is examining things very closely, corporate counsel should make sure that the directors and officers are fully aware of the need to have their own counsel and to ask themselves: Who is watching out for my interests? If a board member or officer does not have his or her own lawyer, the answer is probably "no one," and serious thought needs to be given to rectifying that problem. This can be particularly true in view of the trend toward "deputization," under which witnesses in internal investigations are charged criminally with obstruction and making false statements during interviews conducted by private lawyers because they knew the interview notes would be turned over to the government.

The trends make it clear that counsel for a publicly traded corporation should consider these steps in order to guard against the prospect of litigation. Moreover, if such litigation does arise, counsel needs to ensure that not only is there adequate protection for the company, but also that directors and officers are fully advised regarding their individual issues as well. BLT

Information and Reporting Programs—Delaware Law Requires Them

Over time, the courts in Delaware have reviewed the issue of directors' obligations, including developing a standard regarding compliance programs, through the following cases:

- In 1963, the Supreme Court of Delaware held that "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong . . . [A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963).
- In 1996, the Chancery Court revisited that issue and concluded that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable standards." *In Re Caremark International, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).
- In 2006, the Supreme Court of Delaware approved the *Caremark* standard: "We hold that *Caremark* 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 (Del. 2006).