

Board Turmoil and D&O Risk

In recent weeks, the Hewlett-Packard (H-P) board has struggled to manage the turmoil and adverse publicity from its flawed investigation of media leaks. While the H-P debacle may be the most notorious recent example of board tumult, it is merely one of many instances of problems arising from increased tension inside numerous corporate boardrooms. By way of illustration, since early 2005, the boards of some of the country's largest companies have ousted their CEOs – including Bristol-Myers Squibb, Fannie Mae, Pfizer, Merck and American International Group (AIG). The purpose of this article is to discuss how board turmoil not only generates distraction and adverse publicity, but also increases the possibility of D & O claims activity.

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Sources of Board Turmoil

Increased boardroom tension derives from several causes:

Director Independence: As a result of changes to laws and regulations, independent directors have increasing board representation and clout. According to the National Association of Corporate Directors, in 2005, 83% of boards said that more than half of their directors were independent, up from 54% in 2000. The increasing predominance of independent directors clearly has shifted board participation away from the passive, non-confrontational approach that may have prevailed in the past, toward a more active and even distrustful board dynamic.

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Shareholder Activism: Pressure from the largest activist shareholders – hedge funds and private equity funds that add directors with a specific mandate for change – has added to boardroom tension. A recent prominent example is General Motors' addition of Jerry York to its board under pressure from Kirk Kirkorian. Kirkorian holds nearly 10% of GM's publicly traded shares and has made no secret about his opposition to GM's management leadership and strategic approach. In addition, shareholders are using shareholder votes more frequently than they had in the past to obtain board representation, often

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in active opposition to incumbent management. According to statistics recently published in the *Wall Street Journal*, there have been 80 proxy contests for board seats in the first three quarters of 2006, compared with only 29 proxy fights in 2004, and about 62% of the challenges in 2006 were successful, compared with only 41% in 2004.

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Regulatory Pressure: The continuing fallout from the corporate scandals earlier this decade, as well as New York Attorney General Eliot Spitzer's high-profile public crusade against alleged corporate misconduct, has for some companies generated urgent pressures for change and reform. The removal of Marsh's, AIG's and Bristol-Myers Squibb's CEOs were the direct result of investigative and regulatory pressures.

Mergers: Mergers are another powerful catalyst of tension in the boardroom. Mergers can create an atmosphere of distrust among directors as well as heightened anxiety regarding personal liability for corporate misconduct. For example, the current circumstances at H-P are a direct outgrowth of H-P's controversial acquisition of Compaq; the difficulties following the merger led to finger-pointing, blame-shifting, and ultimately to Carly Fiorina's ouster as H-P's CEO. The leaks of confidential information (which were the result of certain directors' efforts to justify their position and actions and challenge the positions and actions of others) led to the now-notorious investigation following the H-P / Compaq merger.

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Resulting D&O Claims

The H-P debacle illustrates the way that D&O claims can result from boardroom tensions. Prominent plaintiffs' attorney William Lerach of the Lerach, Coughlin, Stoia, Geller, Rudman & Robbins law firm, filed a shareholders derivative suit on behalf of an H-P shareholder against the H-P board. The lawsuit accuses the board and its now-former general counsel (as well as outside investigators) of breaches of their fiduciary duties, abuse of control, and waste of corporate assets as part of the directors' alleged campaign to entrench themselves and to punish or diminish the influence of ousted directors. The lawsuit seeks recovery (for the benefit of the company) of the "enormous" costs and burdens the company has sustained in dealing with the crisis created by the revelations of the Board's "media leak" investigation.

The H-P situation is only one example of many boardroom disputes that have led to D&O litigation. A recent lawsuit battle involving board members at Atmel illustrates the kind of disputes and resulting claims that can arise when activist private fund investors or their representatives have a seat on the board. At Atmel, five dependent board members (representing private equity fund investors) worked together to bring about the firing of company founder and CEO, George Perlegos, as well as other executives, for alleged misuse of corporate travel funds. Perlegos responded by filing his own lawsuit against the Atmel board, arguing that his ouster was illegal because he had already called a shareholder meeting in order to remove the five independent directors. His lawsuit seeks the directors' removal because, "*the hasty, secretive and precipitous manner in which they acted ... will have devastating consequences for the company, including but not limited to loss of the [ousted executives'] decades of experience running the company and a significant loss of shareholder value.*" Disputes between a current board and an ousted CEO frequently spill over into the courts.

Valeant (formerly known as ICN Pharmaceuticals) is engaged in a long-running battle with its CEO seeking the return of bonuses the company paid the CEO in connection with the IPO of a related entity. The former CEO, in turn, has counter-sued the board seeking to enforce a prior agreement regarding the disputed compensation.

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Another example of a shareholder activist lawsuit is the action that Prestly Blake, the founder of Friendly's Ice Cream, filed against Friendly's board. Blake sold his ownership interest in Friendly's in 1979, but in 2001, he bought back a 10% interest. In 2003 he filed a lawsuit against the company and its then-CEO (and current board chair) alleging that the CEO had siphoned off corporate funds and assets for a competing venture in which the CEO allegedly had an interest. The board formed a special litigation committee to investigate the allegations and ultimately filed a motion to dismiss Blake's lawsuit as unfounded. In May 2006, the court rejected the motion to dismiss, holding that the board had not investigated Blake's allegations in good faith. The judge also criticized the board for its "lockstep loyalty" to management.

Coverage Issues

Lawsuits arising from board room tension can present a variety of complications under the typical D&O policy, particularly under the "Insured vs. Insured" exclusion (often referred to as the "I v I" exclusion). The exclusion typically precludes coverage

for claims unless they are brought independent of or without the assistance of any person insured under the policy. The exclusion usually has a carve-out for shareholders' derivative actions, but again only if the actions are brought independent of or without the assistance of insured persons. Cross-claims between directors or between the board and an officer or former officer can also run afoul of the typical I v I exclusion. Or if, for example, ousted directors were to actively support a derivative lawsuit filed against the incumbent board, such a claim could also face potential preclusion under the I v I exclusion.

One aspect of the H-P derivative suit that bears close monitoring is the plaintiffs' specific request from the court that the directors reimburse the company for the expenses caused by the flawed investigation without recourse to indemnity or insurance, even for the costs of defending against the lawsuit.

In addition, many of the remedies sought in lawsuits arising out of board room tensions (e.g., corporate governance remediation, return of compensation, disgorgement, removal of office holders, etc.) typically do not constitute covered "loss" under the D&O policy, or can be precluded by the "personal profit" exclusion. Even so, defense expenses and plaintiffs' fees are likely to be covered loss under the policy and can be substantial.

While many claims arising out of board disputes or tension between boards and senior management may fall at the outer edges of the D&O coverage, not all such claims are automatically excluded. For example, a minority of courts have declined to enforce the I v I exclusion in the absence of collusion between the adversarial insured parties. Few of these kinds of disputes are collusive in nature, and some courts might be persuaded to find coverage even if there are insured persons on either side of these lawsuits. This judicial requirement of collusion for enforcement of the I v I exclusion is not universally followed, and so cannot necessarily be counted upon to limit the effect of the I v I exclusion. Nevertheless, because of these kinds of coverage nuances, it is particularly important for companies whose boards become involved in internal disputes to have knowledgeable claims advocates acting on their behalf and representing their interests. In addition, because of the potential importance of the I v I exclusion in an era of heightened board tensions, it is particularly important for policyholders to have the I v I language in their policy reviewed by a skilled insurance professional who has a comprehensive knowledge of the claims and coverage possibilities that might implicate the I v I exclusion.

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insurance, even for the costs of defending against the lawsuit. While the court might not order this specific remedy, it may well prove to be an issue in any subsequent settlement negotiations. If it turns out that plaintiffs' attorneys can target directors and succeed in withholding both insurance and indemnity, well-intentioned directors could find their personal assets exposed to claims arising from their board service. This possibility of personal liability without recourse, for which no director has bargained, could quickly eliminate the willingness of qualified persons to serve on corporate boards.

Conclusion

A variety of factors are contributing to an increasingly hostile atmosphere in some boardrooms. In such an environment, allegations of wrongdoing can more easily arise and these allegations of wrongdoing inevitably make their way into the courtroom. Thus the newly contentious boardroom atmosphere represents a potentially significant source of increased D&O claim exposure. Because of the kinds of coverage issues these claims present, it is particularly important for boards to enlist the assistance of knowledgeable claims advocates acting on their behalf.

A version of this article previously appeared on *The D&O Diary*, the author's Internet weblog. You access the weblog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to *The D&O Diary* regularly.

About the Author

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