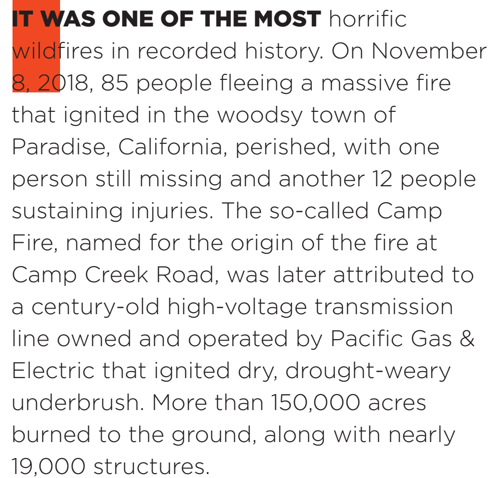
HOW EXPOSED ARE YOU?

AS SHAREHOLDER ACTIONS AGAINST DIRECTORS SPIKE, IT'S TIME TO TAKE A HARD LOOK AT YOUR LIABILITY.

BY RUSS BANHAM



IT WAS ONE OF THE MOST horrific wildfires in recorded history. On November 8, 2018, 85 people fleeing a massive fire that ignited in the woodsy town of Paradise, California, perished, with one person still missing and another 12 people sustaining injuries. The so-called Camp Fire, named for the origin of the fire at Camp Creek Road, was later attributed to a century-old high-voltage transmission line owned and operated by Pacific Gas & Electric that ignited dry, drought-weary underbrush. More than 150,000 acres burned to the ground, along with nearly 19,000 structures.

Within days, reports circulated that PG&E had delayed a safety overhaul of the transmission line implicated in the fire. The next day, the utility's share price plummeted, inciting shareholders to file a traditional securities class-action lawsuit and a separate, so-called "event-driven" derivative shareholder lawsuit against PG&E's board directors for a breach in their fiduciary duties. The litigation was recently settled for an undisclosed amount.

In the aggregate, shareholder securities class-action lawsuits filed against board directors and company officers have more than doubled in the past four years, according to a June 2019 report by insurer Chubb. In both 2017 and 2018, the volume of the litigation filed by plaintiffs on behalf of shareholders in federal courts broke new records. Last year alone, approximately one in 12 public companies was the target of a securities class-action lawsuit, and among the S&P 500, the average was one in 10, according to Cornerstone Research.

To put the upsurge in perspective, plaintiff attorneys representing shareholders filed 165 securities class-action lawsuits in 2009, in the aftermath of the financial crisis. "The litigation occurred at a time when shareholder value had diminished for many companies, in some cases substantially," says Scott A. Meyer, a president, North America Financial Lines, with Chubb. "Yet, in the middle of the third quarter of 2019, when the stock market is hitting new highs, we're approaching the filing of 400 securities class actions, many of them newer event-driven lawsuits, with the number continuing to tick upwards."

NOT A JOB FOR THE FAINTHEARTED

Today's board members have their work cut out for them. As fiduciaries, they must oversee management's control of extraordinarily complex challenges, from traditional acquisitions and IPOs to confounding climate change, cybersecurity, sexual harassment and privacy risks. Inadequate supervision can result in poor management decisions that engender high-speed declines in shareholder value, inciting angry shareholders to file a securities class-action lawsuit against company officers and board members.

Not surprisingly, these knotty business exposures are increasingly on the minds of board members, given their oversight of a company's due diligence. "Seismic changes are underway in the operations of businesses that enlarge the oversight responsibilities of board members," says Mario Spanicciati, former chief strategy officer and current board director at BlackLine, a publicly traded provider of financial and accounting automation software. "We're being tasked to provide oversight on issues that either did not exist a decade ago or have just now come out in the open, like #MeToo. The complexity and speed at which these matters are emerging is remarkable and, for many board members, somewhat alarming."

Directors cite acute concerns over today's fundamentally different operating realities and their individual liability for company actions and inactions. "Institutional investors and other shareholders have put board members on notice that they expect us to become much more engaged in providing guidance on risks like climate change and the handling of social issues, and monitoring them accordingly," says Stephen Kasnet, board chairman at two companies, Granite Point Mortgage Trust and Two Harbors Investment.

Board members who shrug off these demands may regret their complacency, given their considerable personal liability in securities class-action lawsuits filed by

shareholders and event-driven derivative securities class-actions, where directors are sued for failing to ensure the disclosure of an adverse event that may occur and not putting in place sufficient controls to prevent it. In addition to PG&E, board members at Wynn Resorts, Oracle, 21st Century Fox, Yahoo!, Nike and other companies either remain in the crosshairs of event-driven shareholder lawsuits or have recently settled the litigation.

DERIVATIVE LITIGATION LOOMS

"The phenomenon of event-driven litigation is a different category of litigation altogether," says attorney Kevin LaCroix, executive vice president at insurance intermediary, RT ProExec.

As accounting restatements become less common, plaintiff lawyers are shifting their focus from shareholder allegations based on financial misrepresentation and financial omissions to adverse developments in company operations, LaCroix explains. "Something goes wrong at the company, its share price declines, and the company gets hit with a securities suit," he says.

The poster child for event-driven derivative lawsuits is Blue Bell Creameries, a maker of ice cream products whose board allegedly failed to ensure safety measures were in place ensuring its products were free from contamination. In 2015, a deadly listeria outbreak was linked to Blue Bell ice cream, resulting in a major product recall and subsequent decline in shareholder value. Plaintiff attorneys representing shareholders subsequently filed an event-driven derivative lawsuit against the board. Although the suit was dismissed by lower courts, the Delaware Supreme Court revived the shareholder litigation in June 2019.

"With these lawsuits, shareholders contend that the board could have prevented the loss or mitigated it by insisting on certain controls," says Dan Bailey of the law firm Bailey Cavalieri, which often represents insurer defendants in director and officer liability litigation. "It's the board member's job to ask tough questions of management about unexpected events that pose significant risks. It's also up to them to ensure management has taken actions to reduce these risks."

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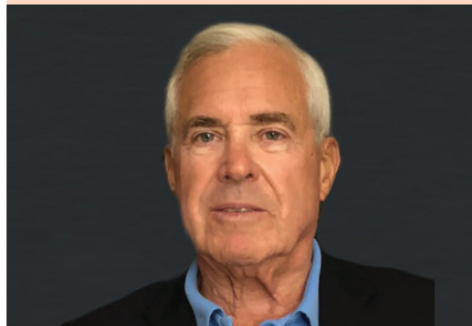

Aside from PG&E, several other high-profile derivative class-actions involve ESG-related events, including a lawsuit filed by plaintiff attorneys representing shareholders of Wynn Resorts. The lawsuit contends that billions of dollars in squandered revenue is attributable to the dozens of sexual misconduct allegations made over the years against Steve Wynn, the company's former CEO and namesake. The complaint alleges the board knew of the serious allegations against the former CEO and yet failed to act on this information.

Like Wynn, former 21st Century Fox CEO Roger Ailes and former broadcaster Bill O'Reilly were among executives alleged to have engaged in a "systemic, decades-long culture of sexual harassment, racial discrimination and retaliation," the shareholder derivative lawsuit against the company states. The complaint alleges the board of directors had failed to take steps addressing these issues or implementing controls to prevent a toxic work culture. The resulting financial harm to the company exceeded $200 million, plaintiff attorneys asserted.

The derivative class-actions filed against Oracle and Yahoo! are unrelated to ESG issues. In the Oracle litigation, plaintiff attorneys representing shareholders alleged the board of directors breached its fiduciary duty in 2016 upon approving a $9.3 billion acquisition of NetSuite, a company controlled by Larry Ellison, Oracle's founder. The lawsuit alleges that directors approved a deal that personally benefited Ellison and not necessarily the shareholders at large.

The derivative action against Yahoo! involves its 2017 acquisition by Verizon for $4.8 billion. Shortly after entering into the acquisition agreement, Yahoo! announced that a data breach against the company, affecting as many as 500 million users, had occurred in 2014. A few months later, the company disclosed an even larger data breach involving the names, dates of birth, telephone numbers and encrypted passwords of as many as three billion users in 2013. The derivative complaint alleges that the board had known about the data breaches well before they were disclosed to the public. By keeping a lid on the information, the directors breached their fiduciary duty for unjust enrichment, the lawsuit contends.

The derivative securities class-action filed against Nike's board of directors may widen the scope of such litigation in future, says LaCroix. The complaint alleges that board directors failed in their oversight duties by allowing a toxic "boys' club" culture of sexual harassment and gender discrimination, leading to compensation and promotion inequities. "Allegations that the Nike board failed in its oversight duties by permitting inequities in pay, advancement and promotion suggest the possibility that the potential liability exposure (for board members)

could sweep much more broadly, suggesting these kinds of lawsuits may extend in the future beyond executives engaging in unwanted sexual advances and sexual contact," notes LaCroix.

In other words, just the presence of a toxic work environment may be grounds for future derivative lawsuits.

RISK TRANSFER COMPLICATIONS

Aside from these startling cases, LaCroix, Bailey and Myers concurred that most event-driven class-action lawsuits are frivolous and dismissed. Those that survive the motion to dismiss generally settle, says Bailey. He estimates that the financial cost of settlements for derivative lawsuits that do not involve a merger or acquisition have increased about 50 percent in the past two years. Meyer says Chubb's data indicates a 40 percent dismissal rate. "Of the litigation that continues, I'd say more than 95 percent settle," he adds.

Sarah D. Downey, managing director and D&O product leader at large insurance broker Marsh, confirms these estimates. "There are a number of newer law firms filing the derivative lawsuits, many of which are frivolous," she says. "With these law firms, it is more challenging to reach a compromise position that is somewhat reasonable, eating up time and money. For the most part, the suits are settled to make them go away."

Resolving the litigation quickly helps contain skyrocketing legal defense expenses, Meyer says. "If you look at what the hourly rates were to defend these suits in 2013, they averaged about $750 an hour for partners and $400 an hour for associates," he explains. "In 2018, they're $1,500 and $550, respectively, on average. To contain these costs, it's just better to settle."

The board directors and shareholders of Yahoo! settled their litigation for $29 million and those at 21st Century Fox for $90 million, considered one of the largest financial recoveries ever obtained in a corporate board oversight dispute. Resolution of the other derivative actions was still in progress as of press time, but expectations are for a settlement.

> **IT'S NOT EASY BEING A BOARD MEMBER TODAY, BUT WE REALLY DO HAVE IT IN OUR POWER TO HELP CHANGE THE WORLD FOR THE BETTER."**
>
> **—Mario Spanicciati**

"From a cost-benefit analysis standpoint, moving to settlement is the preferred resolution," says Jeff Landis, chairman of the litigation practice at ZwillGen. "It's just too much of a long haul otherwise."

While the settlement costs and legal defense expenses generally are insured through a company-purchased D&O policy, companies do not indemnify board members for their potential liability in derivative event-driven litigation. "Under most state laws, a company is prohibited from paying a derivative suit settlement on behalf of the directors," says Bailey. "As a result, the only financial protection available for the directors is a separate D&O liability insurance policy called Side A coverage, which provides optimal financial protection against non-indemnified claims."

However, the veteran attorney points out that no D&O insurance policy provides protection for board members in situations where the company has caused an environmental disaster. "Virtually all D&O policies eliminate coverage for claims that arise out of or are in any way related to pollutants," he explains. In such cases, he urges directors to ensure the organization has purchased environmental impairment liability insurance to transfer the risk to an insurance company.

The spike in the number of both types of securities class-action lawsuits against board directors, added to the rising cost of settlements and legal defense expenses, are ratcheting up the premiums for D&O insurance policies with Side A coverage. "Given increasing litigation frequency and severity and fast-rising legal expense costs, the (D&O) market must respond with higher rates," says Downey.

Meyer concurs that the increases in premium were long overdue. "Our data indicates that the cost to manage securities class-actions has grown 60 percent from 2006 to 2019, whereas our D&O premiums over the period have gone up around 6 percent for primary coverage and a negative number for excess coverage," he says. "We have to reflect in our prices the cost of what happens in Corporate America."

WHEN IPOs TRIP AND FALL

Other recent securities class-action lawsuits involve company IPOs that fail to gain the traction anticipated by shareholders. "When IPO companies stumble out of the blocks, they can attract a securities lawsuit a short time after their debut," LaCroix says.

Recent examples of this litigation include Snap, which was hit with a securities lawsuit a scant two months after its IPO in 2017. Several planned IPOs recently have been postponed, including those of Uber and WeWork (whose CEO stepped down after the failed attempt to take the company public), while home fitness bicycle maker Peloton's IPO has stumbled badly, the company's shares falling 11 percent below its initial IPO price in late-September.

Legally, things may get worse for companies planning an IPO. Bailey cites a recent U.S. Supreme Court decision, *Cyan, Inc. v. Beaver County Employees Retirement Fund*, allowing plaintiffs to file securities class-actions under the Securities Act of 1933 in state courts, which tend to favor the plaintiff more than federal courts do.

"Cyan is a hot issue for IPOs, since plaintiffs get to choose which court, federal or state, they want, and the traditional thinking is that plaintiffs are better off in a state court, as there is less likelihood of a state court judge dismissing the case," Bailey says.

The Supreme Court's decision also grants shareholders the right to challenge the authenticity of the stock registration statements. "If the company's share price falls shortly after the IPO, it's easier now for shareholders to file a securities class-action alleging the company presented false or misleading information in the registration statement," says LaCroix.

Bailey points out one other worrisome potential liability for board members: compliance with the Responsible Corporate Officer Doctrine (RCOD). The strict liability theory gives federal and state governments license to prosecute directors for misdemeanor criminal offenses.

"Assuming there is a statute protecting against a dangerous public welfare situation, a corporate director with the authority to prevent or correct the violation that leads to the dangerous situation can be prosecuted—even though they had nothing to do with the act that caused it," he explains.

Obviously, board membership today requires vigilance. "The days of board members sitting around at meetings and happily collecting their fees are over," says Kasnet. "The job is much, much tougher, requiring people willing to assume substantial responsibilities."

What can board members do to limit the possibility of litigation in an era of escalating CEO commitments to environmental sustainability and a fair and inclusive workplace culture? Ask probing questions of management, the tougher the better. As Spanicciati puts it, "It's not easy to be a board member today, but we really do have it in our power to help change the world for the better, helping ensure the companies we serve do well by doing good." **CBM**

Russ Banham is a Pulitzer-nominated financial journalist and best-selling author.

DERIVATIVE LIABILITY: WHAT TO DO

As investors clamor for companies to heed the business impact of environmental and social risks, board members must ensure attention is paid. Failing to do so can invite a highly publicized event-driven class-action lawsuit that ruins the directors' reputations.

"In light of the recent wave of shareholder derivative litigation, effective board processes in assessing the company's exposure to events like workplace behaviors, cyberattacks and potential environmental liabilities are more important now than ever before," says veteran director and officer liability attorney Dan Bailey, member at law firm Bailey Cavalieri.

It's no longer enough for board members to simply show they've made good-faith efforts to implement oversight systems; they must also monitor these systems, according to a recent Delaware Court Ruling of *In re Clovis Oncology Derivative Litigation*. The Court held that boards must not only be able to show that they have made good-faith efforts to implement an oversight system, but that they also monitor the system, particularly if the company is in a highly regulated industry.

"The fundamental allegations in event-based derivative litigation is that the board should have or could have done more to prevent the event," says Scott A. Meyer, president of North America Financial Lines at global insurer Chubb. "This means the fundamental defense resides in the ability to rebut the allegations. And that means rigorous loss-control measures and solid documentation."

DEFENSIVE TACTICS

Bailey and Meyer recommends six best practices to reduce the risk of event-driven litigation:

• Ensure the company continually discusses its potential exposures to an event-driven risk. "Have management play out for the board all potential scenarios and the impact of these events," Meyer advises.

• Update the board's ERM (enterprise risk management) programs to incorporate their identification and management of event-based risks. "Directors need a baseline to identify areas of potential concern and exposure for the company, ensuring they are reviewing the right metrics and data," Bailey explains.

• Board members must ensure clear and regular documentation of board meetings about event-based exposures. Depending on the state of incorporation, shareholders have free access to corporate books and records. "They can be expected to focus on the level of engagement and rigor given the event-based subjects by the board," Meyer says.

• Consider establishing a board committee dedicated to identifying potential issues generating an event-driven exposure. Alternatively, boards should establish expectations as to how often, and with what level of detail, they can expect feedback from management on event-based risks. "Management from the top down must own it, and the board must ensure it is institutionalized," Meyer says.

• Regular tabletop simulation exercises should be scheduled by the board to prepare a thoughtful response to possible adverse events. "We often find the situation is made worse by a poor response or poor disclosure of the event," says Meyer.

• Lastly, if the board does not have the expertise to advise management on emerging event-based exposures, members should consider retaining the services of outside consultants and attorneys to supplement the perspectives of management in these areas.

The threat of event-driven litigation is expected to increase in the years ahead, both D&O liability experts concur. As Meyer notes, "The bar on what board members need to be doing is rising, as the expectations from shareholders, regulators and the courts continue to grow."