Prevailing Sources of Potential Liability for Private Companies and Their Directors and Officers

Serge J. Adam, Esq., assistant vice president of claims for Monitor Liability Managers, LLC.
Dirk E. Ehlers, Esq., special counsel with Duane Morris, LLP in the firm's Chicago office.

Private companies, by their nature, are less susceptible than public companies to certain liability risks. For public companies, the advantage of access to capital brings with it the enhanced risk of shareholder claims based upon actual or alleged misinformation, whether in the company's mandatory quarterly and annual regulatory filings or in its press releases or other statements to the public. Nevertheless, private companies and their directors and officers are certainly susceptible to significant liability risks.

The following provides an overview of the most significant sources of claims against directors and officers of private companies, with a discussion of factors affecting the viability and frequency of those claims.

Sources of Liability

Employment Practices Liability Claims

The most commonly asserted claims against private companies are employment practices liability claims.[1] Within this subset, the most common are wrongful termination claims.[2] Additional frequent claims include age, race and gender discrimination claims, wage/compensation disputes and breach of employment contract disputes.[3] With economic conditions causing a national unemployment rate nearing 10 percent in the United States,[4] we can expect that employment practices claims will continue to comprise a significant percentage of claims against privately held companies and their directors and officers.

Adding to the effect of job losses related to the economic downturn was the passage of the ADA Amendments Act in 2008, which expanded the scope of the Americans with Disabilities Act[5] to counteract two U.S. Supreme Court decisions that had narrowed the scope of the application of the Act.[6] According to fiscal year 2008 and 2009 statistics for charges of discrimination filed with the Equal Employment Opportunity Commission (EEOC), a record number of 95,402 private sector charges of workplace discrimination claims were filed in 2008 and the figure for 2009 was only slightly below that level, at 93,277. Monetary relief obtained for victims in 2009 totaled over $376 million.[7]

Shareholder Lawsuits

Directors and officers of private companies are not subject to the same type of federal class action securities lawsuits as directors and officers of public companies, and they may take some comfort in a relatively smaller pool of potential shareholder litigants. Nevertheless, they are by no means insulated from shareholder lawsuits; after employment related litigation, the second largest percentage of claims against private company directors and officers are shareholder lawsuits.[8] Within this group of claims, the most prevalent are related to disclosure and financial reporting, with a slightly lower incidence of breach of fiduciary duty claims.[9] Another commonly occurring source of shareholder claims are circumstances in which privately owned companies decide to convert ownership in their company to publicly traded stock.[10] In addition, mergers and acquisitions either involving the company as an acquirer or as a company being acquired may give rise to shareholder claims.[11]

Less common, but still occurring with some regularity, are shareholder claims related to divestiture or spinoffs from the company, claims of breach of fiduciary duty by minority shareholders, contract disputes, and claims related to recapitalization of the company.[12]

Breach of Fiduciary Duties

Directors and officers of public and private companies alike have fiduciary duties to shareholders, and they may incur liability for breach of those duties. Under Delaware law, for example, directors and officers have a duty of care, and interrelated duties of loyalty and good faith.

Duty of Care: The duty of care under Delaware law requires a directors or officer to perform duties with such care as an ordinarily prudent person would use in similar circumstances, and if a director's or officer's decision is based upon a rational business purpose, it will not give rise to liability. Generally, a director's or officer's conduct must rise to the level of gross negligence to give rise to liability. *McPadden v. Sidhu,* 964 A.2d 1262 (Del. Ch. 2008). Nevertheless, directors do have an obligation to inform themselves of all material information reasonably available to them before making a business decision and must act with due care in making such decision. *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 367 (Del. 1993). Compliance with the duty of care requires the active participation of board members, through attendance of and participation in board meetings, proper review of materials and information in connection with decision-making; and proper consideration of opinions of legal counsel and/or other professionals when needed to determine some aspect of proposed action. *Walt Disney Company Derivative Litigation,* 825 A.2d 275 (Del. Ch. 2003); *Official Comm. of Unsecured Creditors of Integrated Health Serv., Inc. v. Elkins,* 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

Duty of Loyalty: The duty of loyalty may be breached if a director or officer uses his or her corporate office or, in the case of a controlling shareholder, control over company activities or structure, to promote, advance or effectuate a transaction between the company and such person (or an entity in which the fiduciary has a substantial economic interest, directly or indirectly) and that transaction is not substantively fair to the company. In addition, as part of a director's or officer's duty of loyalty, such individuals must also act in good faith (*Stone v. Ritter,* 911 A.2d362 (Del. 2006)) and with candor (*Gantler v. Stephens,* 965 A.2d 695 (Del 2009). Acting in good faith not only involves affirmative actions taken by a director or officer, but also includes failing to monitor or oversee a company's internal controls such as to avoid being informed of problems that would otherwise require the attention of the directors or officers. See *AIG v. Greenberg,* 965 A.2d 763 (Del. Ch. 2009).

Breach of the duty of loyalty may occur in a variety of scenarios, such as: (1) transactions between a company and a director or officer; (2) transactions between a company and an entity in which a director or officer has an interest; (3) the buyout of company shares by management; (4) transactions in which a director or officer takes advantage of a business opportunity that otherwise might also have been an opportunity for the company, or the director or officer arguably is competing with the company; (5) transactions between affiliates; (6) acquisitions or reorganization transactions in which a controlling stockholder and minority stockholders have different interests; or (7) use of a position, company property or inside information for purposes that may not be in the best interest of the company.

Creditor Actions

Although a private company may not be obligated to provide financial information to regulators, creditors are a different matter. If a company faces financial difficulty and is unable to pay creditors, those creditors may call into question the accuracy of information they relied upon in extending credit. If any such information was inaccurate, it may give rise to claims of misrepresentation and/or fraud.

In addition, directors and officers of private companies are also susceptible to creditor claims related to their activities preceding bankruptcy, that is once the company has entered the "zone of insolvency". However, it should be noted that following clarification by the Delaware Supreme Court in 2007, it is now clear that under Delaware law, zone of insolvency claims by creditors are limited to derivative claims, and may not be pursued as direct claims.[13] Nevertheless, it is not yet certain whether other jurisdictions that have allowed creditor claims against directors and officers for their acts or omissions in the zone of insolvency will impose that same limitation.[14]

Governmental/Regulatory Actions

Because of the specific reporting obligations of public companies and the corresponding need for their compliance with federal securities laws and regulations promulgated thereunder, directors and officers of public companies are more frequently the subject of regulatory action than their private company counterparts. Nevertheless, there are circumstances where private companies are the subject of federal and regulatory oversight, which in turn makes them susceptible to federal prosecution and/or regulatory action.

Private Company Registration

In certain instances, a private company may be required to file quarterly and annual reports with the Securities Exchange Commission (SEC). Under Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act), a private company with total assets in excess of $10 million or with more than 500 stockholders or stock option holders may be required to register with and to provide quarterly and annual reports to the Securities Exchange Commission, unless the company can establish that it is subject to an exemption.

Under SEC Rule 12g-1, *et seq.*[15] a private company with more than 500 stock option holders (including a non-publicly traded subsidiary of a publicly-traded company that issues options for the purchase of stock that is not publicly traded), may establish exemption from registration if it can meet several criteria: (1) the issuer of the options must not be otherwise registered or required to file reports under Section 12(g) or Section 15(d) of the Exchange Act; (2) the stock options must be issued as compensation for services/incentive for future services provided by the employees, officers, directors, consultants and advisors of the issuer and its subsidiaries, corporate parents, or affiliated companies; (3) the stock options must be issued pursuant to one or more written compensatory stock option plans; (4) the stock option plan must restrict transfers by the option grantee of either the options or securities created by exercise, other than to: (a) family members through gifts/domestic relations orders; (b) an executor or guardian upon the grantee's death or disability; or (c) the issuer (for example, through a repurchase mechanism). In addition, a transfer may be permitted in connection with a change of control or other acquisition of the issuer if, after such transaction, the issuer will no longer be relying on the exemption; (5) if an issuer grants stock options having a value in excess of $5 million in any 12-month period, the issuer must provide the option holder specified financial information at least every six months, including financial statements that may not be more than 180 days old.[16]

Likewise, under Rule 701 of the Securities Act of 1933 (Securities Act)[17] companies can offer their own securities as part of written compensation agreements to employees, directors, general partners, trustees, officers, or certain consultants without having to comply with federal securities registration requirements, but only if they meet certain criteria. Under Rule 701, a company can be exempt from registration requirements only if total sales (not offerings) of stock during a twelve-month period do not exceed the greater of: either (1) $1 million, (2) 15% of the issuer's total assets, or (3) 15% of all the outstanding securities of that class.[18] Nevertheless, all option recipients must be provided with a copy of the benefit plan or contract under which the options or securities are granted, and for total sales over $5 million during a twelve-month period to the delineated recipients permitted by the exemption, companies must disclose additional information, including risk factors, copies of the plans under which the offerings are made, and certain financial statements.

In early 2005 Google, prior to its IPO, was found to be in violation of the registration requirements under Rule 701 in connection with 23.24 million shares of stock and 2.5 million options it had issued as compensation to employees and contractors between 2002 and 2004. Google settled the matter by agreeing to a cease and desist order, and by providing a rescission offer to recipients of the securities and options that had been issued without proper registration and disclosure.[19]

State Registration

In addition to federal registration requirements, private companies may also be subject to additional registration or reporting requirements under state law. Exemption under federal law may not necessarily eliminate a need for registration at the state level.

The Foreign Corrupt Practices Act

The U.S. Foreign Corrupt Practices Act of 1977 (FCPA)[20] generally prohibits U.S. companies and citizens, foreign companies listed on a U.S. stock exchange, or any person acting while in the United States, from corruptly paying or offering to pay, directly or indirectly, money or anything of value to a foreign official to obtain or retain business.[21] The FCPA is jointly enforced by the Department of Justice (DOJ) and the SEC,[22] and it applies not only to issuers of publicly traded securities, but also to "domestic concerns," which include "any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship" with a principal place of business in the United States or organized under U.S. law.[23]

During the past several years the DOJ and SEC have stepped up enforcement of the FCPA as to both public and private companies.[24] On August 5, 2009, the SEC's Director of Enforcement, Robert Khuzami, announced the formation of a new specialized enforcement unit to focus on the FCPA, and he noted that "while we have been active in this area, more needs to be done, including being proactive in investigations…"[25] On November 12, 2009 Lanny Breuer, Assistant Attorney General in the Criminal Division of the DOJ delivered a speech in which he advised that the DOJ would be focusing FCPA enforcement efforts upon the pharmaceutical and medical supply industry.[26]

These SEC and DOJ predictions were certainly accurate. In a connection with the military and law enforcement products industry, on January 19, 2010 the DOJ announced the indictment of 22 executives and employees of various companies as the result of an FBI undercover operation.[27] On February 23, 2010 Eli Lilly reported that the DOJ and SEC were expanding their investigation into its compliance with the FCPA.[28] Private companies doing business with foreign counterparts should anticipate increased scrutiny, and a continued increase in investigative and enforcement activity by the DOJ and SEC in connection with the FCPA

Additional Specialized Regulatory Oversight

Private companies in certain industries may also be the subject of regulation by regulatory agencies by virtue of the nature of their activities. Entities that frequently investigate and pursue claims against both public and private companies include the

Food and Drug Administration, the United States Department of Agriculture and both state and federal bank regulators. Alleged violations of regulations by directors or officers of such companies may result in either informal or formal administrative action, and/or civil or criminal litigation.[29]

The Role of Insurance

A first line of risk mitigation for a director or officer of any company is a right of indemnification from the company itself. However, whether a company is public or private, this source of protection has its limitations. First, the scope of permissible indemnification varies greatly from one company to another, according to the applicable state law, a company's charter and/or by-laws and contractual arrangements between the company and its directors and officers. Moreover, even where directors' or officers' right to indemnity is clear, if a company is financially challenged, it may lack the means to indemnify its directors or officers. The capability of a company to handle such risk in the current economic climate may be even more acute due to the reduction of access to credit.

For directors or officers who themselves own a significant stake in a private company, their net worth may be threatened even in the absence of any personal liability. The value of their personal stake in the company may be diminished if their company's value is depleted as a result of a significant indemnification obligation.

The purchase of directors' and officers' liability insurance avoids these concerns by creating a source of funds that is independent of the company's assets and the personal assets of its owners and/or directors and officers. In providing this safety net, such products further ensure that a company can offer its board members and management the best measure of security and lowest measure of risk, which in turn positions the company to target and to retain the best-qualified people to serve on its board and in its management ranks.

Footnotes

[1] Towers & Perrin 2007 Survey of Purchasing Trends, p. 55; Towers & Perrin 2008 Survey of Purchasing Trends, pp. 46-7.

[2] Towers & Perrin 2007 Survey of Purchasing Trends, p. 60.

[3] *Id.*

[4] U.S. Bureau of Labor Statistics, Employment Situation Summary, March 5, 2010.

[5] 42 U.S.C. 12101.

[6] ADA Amendments Act of 2008, which expressly rejected several findings of the *Supreme Court in Sutton v. United Air Lines, Inc.,* 527 U.S. 471 (1999) and *Toyota Motor Manufacturing, Kentucky, Inc. v. Williams,* 534 U.S. 184 (2002).

[7] EEOC January 6, 2010 Press Release, "Job Bias Charges Approach Record High in Fiscal Year 2009, EEOC Reports, and EEOC March 11, 2009 Press Release, "EEOC REPORTS JOB BIAS CHARGES HIT RECORD HIGH OF OVER 95,000 IN FISCAL YEAR 2008."

[8] Towers & Perrin 2007 Survey of Purchasing Trends, p. 55; Towers & Perrin 2008 Survey of Purchasing Trends, pp. 46–7.

[9] Towers & Perrin 2007 Survey of Purchasing Trends, p. 59.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *North American Catholic Educ. Programming Foundation, Inc. v. Gheewalla,* 930 A.2d 92 (Del. 2007). See *Carrieri v. Jobs.com, Inc.,* 393 F.3d 508, 534, n. 24 (5th Cir. 2004); *In re Rajabli,* 365 B.R. 702, 709 (S.D. Tex. 2007) and *3 Point Holdings, L.L.C. v. Gulf South Solutions, L.L.C.,* Civ. No. 06-10902 (E.D. La. Mar. 13, 2008), in which courts applying Texas and Louisiana law allowed direct breach of fiduciary duty claims by creditors against directors and officers for their alleged activities while in the zone of insolvency.

[14] See *Carrieri v. Jobs.com, Inc.,* 393 F.3d 508, 534, n. 24 (5th Cir. 2004); *In re Rajabli,* 365 B.R. 702, 709 (S.D. Tex. 2007) and *3 Point Holdings, L.L.C. v. Gulf South Solutions, L.L.C.,* Civ. No. 06-10902 (E.D. La. Mar. 13, 2008), in which courts applying Texas and Louisiana law allowed direct breach of fiduciary duty claims by creditors against directors and officers arising from their alleged activities while in the zone of insolvency.

[15] 17 CFR § 240.12g-1, *et seq.*

[16] *Id.*

[17] 17 CFR § 230.701, *et seq.*

[18] Cite section of 701.

[19] See *In the Matter of Google, Inc. and David C. Drummond,* SEC Release No. 8523, January 13, 2005, Admin. Proc. File No. 3-11795, "ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933."

[20] 1515 U.S.C. §§ 78dd-1, *et seq.*

[21] 15 U.S.C. §78dd-1(a) and §78dd-2(a).

[22] See, e.g., 15 U.S.C. §78dd-1 to § 78dd-3, and 15 U.S.C. §78ee, providing for Attorney General oversight, allowing for DOJ and SEC involvement and consultation in connection with the enforcement of the FCPA and assessment of penalties and sanctions.

[23] 15 U.S.C. §78dd-2(a), and 78dd-2(h)(1)(A)-(B).

[24] Dionne Searcey, "U.S. Cracks Down on Corporate Bribes," Wall Street Journal May, 26, 2009, p. A1, which quoted DOJ Deputy Chief Mark Mendelsohn as advising that at least 120 companies were then under investigation.

[25] Robert Khuzami, SEC Director of Enforcement, "Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement," August 5, 2009.

[26] Lanny A. Breuer, Assistant Attorney General, Criminal Division, "Prepared Keynote Address to The Tenth Annual Pharmaceutical Regulatory and Compliance Congress and Best Practices Forum," November 12, 2009.

[27] Department of Justice, Office of Public Affairs, January 19, 2010 News Release, "Twenty-Two Executives and Employees of Military and Law Endorcement Products Companies Charged in Foreign Bribery Scheme."

[28] Peter Loftus, Dow Jones Newswires, February 23, 2010, "US Expands Probe of Lilly & Co's Compliance With Antibribery Law."

[29] The current FDIC activities in connection with the financial crisis provide a dramatic example. The FDIC has closed more than 230 banks in the past 2 year period (see FDIC Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html, accessed May 19, 2010), and it has recently added 1600 people to its workforce and increased its budget by 55 percent to handle failed bank matters. Jeff Clabaugh, "FDIC Hiring 1,600 to Handle Bank Failures," *Washington Business Journal,* December 15, 2009. If regulatory activities during the financial crisis of the 1980's to 1990's's are any guide, we should expect that the FDIC's current review and investigation will result in a wave of civil and criminal claims against directors and officers of privately held banks across the country. See Federal Deposit Insurance Corporation, "Managing the Crisis: The FDIC and RTC Experience, 1980-1994," pp. 265-87, August 1998, http://www.fdic.gov/bank/historical/managing/history1-cr.pdf.

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LIABILITY MANAGERS, LLC
A Berkley Company

2850 West Golf Road, Suite 800 Rolling Meadows, IL 60008
www.monitorliability.com (800) 446-2100