WHALEN LLP NEWSLETTER

10 Things Outside Directors Should Know About Public-Offering Liability

LIABILITY FOR OUTSIDE DIRECTORS IN PUBLIC OFFERINGS

The securities laws require you, as an outside director, to ensure that the registration statement filed in connection with a public offering is correct and complete. If it is not, you may be liable even though you were unaware of any faulty disclosure.

Fortunately, the law provides you with defenses to this liability, a reliance defense for the audited financials and a due-diligence defense for the remainder of the registration statement. To set up these defenses, you must take active steps during the registration process.

YOU ARE A POTENTIAL TARGET

Directors are routinely named as defendants in fraud suits brought in connection with public offerings. In fact, some institutional plaintiffs specifically seek recoveries out of the personal assets of directors.

The New York State Common Retirement Fund, lead plaintiff in the WorldCom litigation, gave a warning to outside directors: *"We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud."*

In a similar vein, the State of Wisconsin Investment Board reportedly offers its attorneys higher contingency fees for collecting from individual defendants, including directors.

FOR WHAT CAN YOU BE SUED?

If the price of your company's stock goes down after a public offering, plaintiffs' attorneys will review the registration statement very carefully. Using 20-20 hindsight, they will look for faulty disclosure: false statements or omissions.

If your company has a financial restatement after the offering, it is practically guaranteed they will find faulty disclosure, because if the restated financials are correct, then the old financials must have been incorrect.

If there was faulty disclosure, you may be held to be personally liable for a portion of the plaintiffs' damages under Section 11 of the federal Securities Act of 1933 unless you can prove that you qualify for one of the affirmative defenses under that section.

USING "FIRST-CLASS PROFESSIONALS" IS NO DEFENSE.

Many directors feel that they will meet their obligations if they involve reputable professionals to handle the public offering. Unfortunately, even if management, inside counsel, outside counsel, underwriters and underwriters' counsel are first-class, you are not entitled to rely on them as a defense against Section 11 liability. Instead, to establish a defense, the law requires you to do your own diligence on the registration statement and to look out for "red flags" in the audited financials.

In the WorldCom litigation, director Bert Roberts argued in his defense that he shouldn't be liable because he relied on other directors, experts and professionals. The court rejected his argument. Roberts paid $4.5 million out of his own pocket in the resulting settlement.

THERE IS NO "SERGEANT SCHULTZ" DEFENSE

Can you be liable even if you didn't know about any faulty disclosure? *Absolutely.*

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The law does not require plaintiffs to prove you knew anything was wrong or omitted. They only have to show that the registration statement contained a material misstatement or omitted material information that should have been included.

CAN YOU RELY ON YOUR CORPORATE INDEMNITY AND D&O INSURANCE?

Unfortunately, you can't always collect on indemnities and insurance. The directors of Enron and WorldCom learned this the hard way. Those directors agreed to pay out of their own pockets to settle the litigation against them: the WorldCom directors paid $24 million and the Enron directors paid $13 million.

Some circumstances where it may be difficult or impossible for you to collect on your corporate indemnity are:

- The company could be bankrupt when you try to collect.
- The company may not want to pay you and may force you to sue it to collect. You may have to pay your own expenses of suing the company to collect on the indemnity.
- You may not be able to collect because the plaintiffs show you did not act in good faith.

Depending on the exact wording of the company's D&O policies, it may be difficult for you to recover all your losses from the carriers in some circumstances. For example:

- If the company gave false information (for example, false financial statements as may be the case if there is a later restatement) in its application, the insurance company may try to rescind the policy and deny coverage.
- The policy limits may be exceeded.
- You may have to split the coverage with the officers and other directors.
- Defense costs will reduce the coverage available.
- Bad acts of management may make the policy void.
- A company bankruptcy may interfere with your ability to collect on some policies.
- The policy may be subject to fraud, improper personal benefit and other exclusions.
- Allocation provisions may allow the carrier to try to limit its coverage to a percentage (less than 100%) of the claims.

"We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud."

- Alan Hevesi, New York State Common Retirement Fund

THE "DUE DILIGENCE" DEFENSE REQUIRES REAL EFFORT

You can defend yourself against liability under Section 11 by proving you conducted a reasonable investigation, i.e., due diligence. Unfortunately, the law does not give a checklist of the steps you need to take in due diligence. What is clear is that you have to put in the effort to make a reasonable investigation. In particular, you are not allowed to rely on the company's attorneys or management to do the work for you. Some specific steps you can take are discussed below.

THE "RELIANCE" DEFENSE MAY BE AN ILLUSION

The reliance defense allows you to rely on the audited financials if you reasonably believe them to be correct. This means you are not required to diligence the audited financials.

However, you cannot rely unless you had "reasonable" grounds to believe the audited financials were correct and complete. If there were "red flags" in the financials (information that

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would cause one to question the audited financials), the reliance defense is not available. As a result, we believe that you should not plan to rely on the audited financials except after conducting enough diligence of the audited financials to satisfy yourself that there are no red flags.

WHAT CAN YOU DO TO PROTECT YOURSELF?

We believe directors should review their corporate indemnities and D&O policies to ensure that they have up-to-date provisions, and, in the case of the D&O policies, are in sufficient amounts. Directors should also review the registration statement carefully and put in the effort to properly diligence the information it contains. In addition, directors should review the company's audited and unaudited financial statements carefully, with an eye toward spotting possible red flags.

Outside directors may consider hiring experienced independent counsel (which may be done at the company's expense) to assist the directors with these tasks.

Independent counsel can advise the outside directors as to the registration process and can prepare a record that documents the diligence efforts undertaken by the outside directors. This record may be very valuable to the directors if they ever need evidence of their due-diligence efforts.

20 SPECIFIC STEPS TO TAKE

We have prepared a list of 20 specific steps to take in registration statement diligence that may help directors to establish their defenses. If you would like a copy of this list or if you have any questions regarding director diligence, please contact Michael Whalen (mwhalen@wllpweb.com), Phyllis Schneider (pschneider@wllpweb.com), Karen Goodin (kgoodin@wllpweb.com) or Kirsten Foos (kfoos@wllpweb.com) of Whalen LLP at (714) 384-4340.

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