Executive Risks

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Spotlight on Recent Executive Risks Decisions

If you're the betting type and think you can predict the outcome of Executive Risks court cases, we humbly suggest you keep your money in your pocket. In this newsletter, we report on some noteworthy recent decisions.

In the Disney case regarding the hiring and firing of president Michael Ovitz, the defendant won – outraged headlines notwithstanding. In one Employee Retirement Income Security Act (ERISA) case in California, the defendant won again – but not before agreeing to a settlement of close to a billion dollars to conclude the Directors & Officers (D&O) securities suit that launched the case in the first place. Lest anyone think that locale is an indication of how the courts will decide, another California case saw the plaintiffs win a key ruling that pushed their ERISA case forward. And finally, in a third ERISA case, plaintiffs won a stunning reversal of a district court decision – which reversal, issued by the Third Circuit, directly contradicted a ruling by the Fifth Circuit in a similar recent case. All of the above proves our point: oddsmakers beware. And, by the way, the cases that have been decided are under appeal.

Our emphasis on ERISA cases is no accident: there is little case law in this area, and we welcome the opportunity to delve into these proceedings. Few cases go to adjudication as the overwhelming majority of cases settle. So we are pleased to take a look at what the courts are doing, confusing as it may be.

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Walt Disney: Triumph for the Business Judgment Rule

In a decision that surprised some and relieved others, the Delaware Chancery Court ruled that the board of The Walt Disney Co. did **not** breach its fiduciary duties in hiring Michael Ovitz as president in 1995 and paying him $140 million in severance after 14 months of service.

Huh?

The *surprise* is that the strongly worded decision came from the same court that, back in 2003, allowed the shareholder derivative suit to continue while denying the directors indemnity from the corporation. The earlier court held that acts or omissions not undertaken honestly and in good faith, or which involve intentional misconduct, are not protected. It found that the plaintiffs' allegations gave rise to a cognizable question: should the defendant directors be held personally liable to the corporation for a knowing or intentional lack of due care in the directors' decision-making process regarding Ovitz's employment and termination? The court found that the plaintiffs' complaint suggested that Disney directors failed to exercise *any* business judgment or make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders.[1]

After a lengthy, closely watched trial, the court found that, while corporate governance practices were not the best at the time of Ovitz's hiring, the board did not violate any legal obligations it had to the company or its shareholders by hiring the executive.

[1] *In re The Walt Disney Company Derivative Litigation Consolidated*, C.A. No. 15452, Court of Chancery of Delaware, 825A.2d 275

Whew!

The *relief* stems from the court's strong affirmation of the principle that management be given leeway in decision making under the business judgment rule. Cases such as this one, involving corporate directors' alleged breach of the duty of care, are typically subject to review under the director-protective business judgment rule, assuming the decision made was the product of a process that was either deliberately considered in good faith or was otherwise rational. Corporate waste is rarely found by Delaware courts because the applicable test imposes an onerous burden upon a plaintiff to prove that an exchange is so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.

But –

While the Delaware court didn't side with the plaintiffs, the judge made it clear that he was not holding the board's 10-year-old decisions to newer 21st-century, post-Enron standards, the implication being that in the current environment of heightened expectations, the judge might have considered the case differently. Furthermore, legal observers suggest that the publicity surrounding this case along with the very fact that the suit was filed have already affected boardroom decisions, making directors more sensitive to the size of total compensation packages. With other compensation-related cases awaiting trial, both sides will no doubt be citing this decision.

ERISA Tagalong Suits

ERISA tagalong suits are law suits that essentially restate and recast the allegations of a D&O securities claim in the language of ERISA on behalf of the employees and beneficiaries of the company's pension plans that held the company's securities. While these cases have sometimes resulted in large settlements (a recent suit on behalf of Rite Aid Corp. employees and pensioners resulted in a $68 million settlement), there is no well-established body of law to cite when examining the merits or assessing the outcome of these suits.

In re JDS Uniphase: Potential Board Liability in ERISA Tagalong Suits

In *In re JDS Uniphase Corp. ERISA Litigation*, the plaintiffs alleged that current and former directors of the company, along with members of the Benefits Committee and others, breached their fiduciary duties regarding the company's 401(k) plan by making imprudent investments in company stock while negligently failing to disclose material information about the future value of the stock to the plan participants.

The case focused in part on the status of the director defendants as ERISA fiduciaries. The plaintiffs consistently alleged that the directors exercised discretionary authority in the management and administration of the plan (the hallmark of ERISA fiduciary status). The California court maintained that the director defendants are only fiduciaries to the extent that they exercised discretionary authority under ERISA's functional definition. However, it also held that this requirement was met by the allegation that the board of directors had the discretionary authority to hire and fire the individual plan fiduciaries, and consequently had the responsibility to monitor those individuals selected. The court went on to find that the mere allegation that the defendants should have known that investing in the company's stock was imprudent was sufficient to withstand the challenge to dismiss at this stage, and the court allowed this charge to continue.

The defendants contended that they should not be held liable for any potential breach of ERISA's fiduciary duty in holding the company's shares, because the losses were unavoidable: to have divested the plan of the shares would have required disclosure that (1) the plan was selling the company's own stock and (2) the reasons for doing so. Such disclosure itself would then have resulted in the immediate decline in value of the very shares being sold. The court withheld opinion on this defense and considered dismissing this charge since the plaintiffs also alleged that there had been a breach of duty in first making and continuing to make the investment – not just in failing to divest the fund of the shares. In some intriguing dicta, this court commented that "[m]oreover, courts generally have rejected the notion that the securities laws immunize ERISA fiduciaries against liability for imprudent investment, including failing to disclose information to participants." The court is permitting this case to proceed.

In re McKesson HBOC Inc.: Possible Conflicts between ERISA & Securities Disclosure Requirements

The issue of whether or not alleged ERISA fiduciaries have any responsibility to act on nonpublic information was also the focus of another California court in *In re McKesson HBOC Inc. ERISA Litigation*. In this decision, the judge reached a contrary decision: that the board of directors would have been barred from divesting the company's 401(k) plan of company stock because the information prompting such a move was still confidential; and therefore the board could not be held liable for any resulting losses to the plan.

The court held that members of the McKesson board, including members of the board's Compensation Committee, may, under appropriate circumstances, be liable for the selection of company stock as an investment alternative, but rejected several other federal decisions that have found that insider trading rules would **not** be violated by the disclosure of nonpublic information to plan participants. The judge dismissed the lawsuit, noting that "selective disclosure" of the nonpublic information would benefit plan participants "at the expense of general shareholders" and that nothing in ERISA suggests that it "renders federal securities statutes inapplicable." Furthermore, according to the court, "participants do not need a remedy under ERISA to obtain relief for a fiduciary's false statements or omissions; indeed, they can invoke the securities laws."

The only possible breach of fiduciary duty claims that could be asserted against the board, according to this court, were claims for failure to monitor the Administrative Committee, failure to communicate information to the trustee or Administrative Committee necessary for the proper performance of their duties, and/or failure to provide a mechanism for communicating with participants. The court, however, dismissed the claims against board members with leave to replead on grounds that they were "wholly conclusory," with no facts alleged to support them.

As is standard for ERISA tagalong claims, the plan in this case held the company's stock. In fact, McKesson's plan provided that all matching company contributions be made in the form of company stock or cash, and that cash contributions be converted to company stock "as soon as practicable." Subsequent to the merger of McKesson and HBOC, all McKesson common stock held by the plan was converted into McKesson HBOC common stock. Shortly thereafter, the new company publicly announced that HBOC had engaged in improper and illegal accounting practices. The company's stock price then dropped precipitously and the pension plan lost over $800 million in market value, resulting in D&O securities claims as well as ERISA claims

In 1995, In *Moench v. Robertson*, the US Court of Appeals for the Third Circuit held that an employee stock ownership plan (ESOP) fiduciary is "entitled to a presumption that it acted consistently with ERISA" when investing in the plan sponsor's securities. To rebut that presumption, plaintiffs have to introduce evidence that "owing to circumstances not known to the settlor and not anticipated by him [the making of such investment] would defeat or substantially impair the [purposes] of the trust."

The court in *McKesson*, however, may have gone beyond current precedents in determining that the plaintiffs were required "to allege underlying facts that demonstrate that the fiduciaries abused their discretion in continuing to hold such a high percentage of company stock."

Any celebration at McKesson HBOC, however, is likely to be muted given the outcome of the D&O securities case that launched the tagalong suit. The company agreed to a settlement that will pay shareholders $960 million to cover losses they suffered as a result of an accounting scandal at McKesson during the acquisition of HBOC. There are reports of 16 additional related lawsuits that remain unresolved.

Schering-Plough: ERISA Derivative Action Permitted

In a stunning reversal of a 2004 district court decision, the Third Circuit recently held on appeal that plan participants in an ERISA tagalong action against Schering-Plough could continue their claims brought on behalf of the plan, despite the fact that not all

plan participants were affected by the alleged fiduciary failures. This landmark decision remanded the case back to the lower court, holding that, "...the Plaintiffs may seek money damages on behalf of the fund, notwithstanding the fact the alleged fiduciary violations affected only a subset of the saving plan's participants."

The Department of Labor (DOL) had filed an *amicus* brief in the appeal, arguing that a breach of fiduciary duty didn't need to harm the entire plan to give rise to liability under ERISA and that to decide otherwise would have the effect of insulating fiduciaries who breach their duty so long as the breach did not harm all of a plan's participants. The DOL also noted that "[s]uch a result clearly would contravene ERISA's imposition of a fiduciary duty that has been characterized as 'the highest known to law.'"

This decision was reached in the face of a decision earlier this summer by the Fifth Circuit in a similar action brought against American Airlines where the court held that the plan participants lacked standing to bring a suit on behalf of the entire plan when only a subset of plan participants had actually suffered harm.

Unsurprisingly, the outcome in other circuits remains unclear. Several cases are currently pending in the Fifth Circuit, including a rehearing *en banc* (or by the full appeals court) of *American Airlines*.

As the complex and costly process of litigating ERISA matters continues, a body of case law will emerge that will allow us – we hope – to better predict the outcome of these proliferating cases.

The analysis provided here should not be regarded as legal advice on which to base any legal decisions regarding the issues discussed; any legal decisions should be made with the help of counsel; legal circumstances vary according to jurisdiction and the specifics of each situation.

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