

# Acredula

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Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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## Loss Prevention Counsel Help To Minimize Third-Party Liability

The focus of this issue is "keeping barbarian plaintiff attorneys away from the board." The feature article, "Counsel Is Best Defense Against Loss For Boards," was written by litigator Quintin Lindsmith, who has built a reputation as defense counsel for boards of directors and executive officers. He has experience not only in the courtroom as defense counsel, but also in the boardroom as "loss prevention counsel." As such, Quintin advises both boards and executives on how to avoid potential litigation by third parties. The best testament to Quintin's reputation and experience is that the lawyers of Bricker & Eckler have personally appointed him as both their defense counsel and loss prevention counsel.

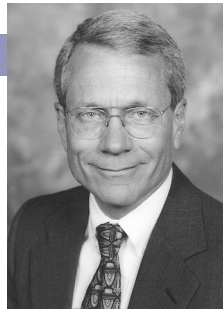
Michael F. Sullivan, a corporate transaction attorney with extensive experience in dealing with board and executive issues, recommends that boards and executives have independent loss prevention counsel that serves their interests exclusively. The reason for independent counsel is to assure the protection of the attorney-client privilege. Mike offers the following four

### Editor's Note

uses of loss prevention counsel by boards and executives:

1. Assuring that relations with the corporation have been crafted to minimize the areas of risk. This includes D&O insurance audit and indemnification tightening.
2. Presenting the smallest target possible to potential plaintiffs by minimizing easily discoverable written roadmaps.
3. Fully utilizing the protective shield of attorney-client privilege before lawsuits are filed.
4. Insisting on the availability of information and opinion resources which can provide a dead stop defense to some lawsuit initiatives.

This issue of *Acredula* explores how to keep litigation out of the boardroom by utilizing sound risk management and loss prevention techniques offered. Our next issue of *Acredula* will feature an article by Mike Sullivan exploring how to avoid the four most common mistakes made by directors.



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# Loss Prevention in the Boardroom: Keeping Blood Off the Walls

**B**arbarians. They will always be at the gates. Always. And there are two sets of gates that every company should be concerned about. The first are the gates to the courthouse. Barbarians commonly breach these gates by simply naming a corporation in a lawsuit.

The second and more important set of gates are the gates to the boardroom. If the litigation barbarians are able to enter the boardroom by naming individual directors, the plaintiff almost automatically has improved leverage. Even in a completely baseless lawsuit, if the plaintiff can crash into the boardroom, the nuisance value alone becomes a higher quality nuisance value which may provide the plaintiff with some settlement leverage where before it had virtually none.

Litigation, after all, is simply a tool by which each party tries to create stronger leverage to secure a more favorable resolution. The fact that only about ten percent of all lawsuits actually go to trial is an indication that parties use litigation more as a leverage-building tool to settle and less often as a tool to conquer. If Clausowitz was right and war is only an extension of diplomacy by other means, then litigation is only an extension of settlement discussions by other means. Whoever performs better on the battlefield has greater leverage in discussions at the peace table. If, however, the battle invades the high command, the battle becomes more dangerous and leverage shifts.

The focus of this article is not how to keep the litigation barbarians out of the courtroom, but how to keep them out of the boardroom.

In today's litigation climate, it is almost inevitable that any corporation which has been in operation for any material period of time will be sued. The lawsuit may come from any direction - from the work force, a competitor, a transaction gone bad, a shareholder, or even a class action purportedly representing a group of customers of the corporation. Yet, very generally, it remains the exception that a director is named as a defendant in a lawsuit and it is even rarer for a director to have serious risk of personal exposure that could result in a loss of personal assets.

There are a number of reasons for this. In most jurisdictions, officers and directors of a corporation cannot be named individual defendants in a lawsuit arising out of a contract dispute. Thus, even where an officer or director might personally orchestrate an egregious breach of contract, it remains that it is the corporation which is the party to the contract and, unless the corporation itself is deemed a sham, most jurisdictions do not allow officers and directors to be named in such lawsuits. Thus, a large category of business litigation is removed from the area of exposure to directors.

In lawsuits where tort claims are brought against the corporation, such as negligence or fraud, most jurisdictions require that before a director can be named as a defendant, the director must have actually participated in the tort at issue. That is, the director must have actively participated in the fraud or actively participated in the negligence. Such tort claims might more easily enter the boardroom in closely-held corporations where the directors are often officers directly involved in the operations of the business. They are less likely to enter the boardroom of large, publicly held corporations where most directors are rarely involved in the day-to-day activities of the corporation.

Other reasons for limited personal exposure to directors include the common purchase of director and officer liability insurance. Also, absent egregious wrongdoing, most directors are entitled to indemnification by statute, bylaw, or, increasingly, by contract.

In spite of the foregoing, significant risk to directors remains. And even if the barbarians are repulsed dozens of times, one breach can change a director's life. Simply being named in a completely frivolous lawsuit seeking \$1 million can have a swift impact on a director who, for example, would like to refinance

her home. She will find she has difficulty explaining to the loan officer that there is really nothing to worry about concerning that lawsuit which she had to disclose on her loan application. It is likely the loan officer would tell her that she would have to resolve that claim before the bank would approve the loan. If the lawsuit drags on for even six months, rates could move up and the lawsuit could cost her even if she is completely covered by insurance and completely indemnified by the company.

Perhaps the most common vehicle through which a litigation attack can crash into the boardroom is a claim of breach of fiduciary duty. Directors have a fiduciary duty to the corporation and its shareholders. They must act in the best interests of the corporation and the shareholders and must avoid self-dealing. Many jurisdictions expand a director's fiduciary duty to creditors of the corporation whenever a company becomes insolvent. That is, on the day the company's balance sheet goes from a positive net worth to a negative net worth of even \$1, directors suddenly have a new constituency to whom they owe a fiduciary duty.

The most common shield against such an attack is the Business Judgment Rule. In non-legal terms, the Business Judgment Rule provides that directors may not be held liable for a bad business decision as long as that decision was made in good faith and with disinterest. (You don't want to hear it described in legal terms.) For example, if a clothing retailer has disastrous sales because the board made a strategic decision to go into polka



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dots when the fashion market was clearly going to stripes, the shareholders might vote differently in the next board election, but they do not have a claim for breach of fiduciary duty. The result might be very different, however, if members of the board majority who voted in favor of polka dots happened to own the vendor company which supplied the polka dots to the corporation.

Barbarian avoidance for corporations is commonly referred to as risk management or loss prevention. Board members should consider whether enough is being done to assure loss prevention in the boardroom. Loss prevention does not mean simply winning lawsuits. Loss prevention must have as the primary goal keeping the boardroom doors closed to the barbarians.

The mere commencement of business litigation is akin to entering into a double inverse, regressive tax bracket - the winner pays a huge tax on its earnings and the loser pays a huge tax on its losses. The tax, of course, is in the form of attorney fees, inordinate attention of management away from operations of the business, and perhaps even business disruption. The tax only gets higher when the litigation enters the boardroom. Thus, a loss prevention program for the boardroom must be designed like the Russian front in World War II - it should have several lines of defense, each one deeper within and stronger so that the litigation barbarian ultimately finds it insurmountable and never enters the boardroom.

Now let's see. To whom should the corporation turn to construct those lines of defense? You have probably guessed by the simple fact that this article is written by a lawyer that such a person should be - counsel! If you have an in-house counsel staff, do not look upon them simply as a cost center. Use them! They could actually save you money. The same is true of outside counsel if you do not have an in-house staff.

It is often the case that business leads and law firms follow. That is, it is typically law firms which follow business trends and almost never lead them. Yet, in the field of loss prevention, many large law firms have sophisticated loss prevention programs that include the designation of a loss prevention partner. Such loss prevention programs are designed to keep the barbarians out of the partnership. Yet, the use of a loss prevention counsel in the boardroom is almost unheard of. So, what would a loss prevention counsel do for the board?

Among the first things a loss prevention counsel would do is to examine the extent and adequacy of director and officer liability coverage. Counsel would examine exactly what types of claims the policy covers and, more importantly, the types of claims it would not cover, such as business slander or breach of fiduciary duty. Counsel may determine that policy limits are too low in view of the nature of the size of the business and the size of common transactions. Counsel may also conclude that exclusions of coverage are unacceptable and it may be desirable to shop around for additional coverage.

Counsel should likewise review again the company's by-laws to make sure that the directors are adequately protected from the indemnification provisions of the by-laws which would fill the gaps in insurance coverage, including any deductible. Counsel

should also consider whether board members should be indemnified by contract. This provides additional protection to board members in the event there occurs a hostile change in ownership or control. The new hostile ownership might be able to change the bylaws, but cannot change the contract. But this is just the beginning.

The most effective use of counsel is not posting him or her outside the boardroom gates. It is in the boardroom. The cloaking powers of counsel in the boardroom are rather remarkable, especially when one considers how rarely they are used.

Consider the attorney-client privilege. If the company is facing a sensitive strategic issue which may largely be a business issue but which has some legal aspects, the discussion at the board level can be protected from disclosure by simply inviting counsel in the boardroom to participate in the discussion in the express context of the board consulting with counsel. The minutes would reflect no more than one sentence that "the board participated in a privileged discussion on the subject matter with counsel." That is it. It is privileged. Even if it turns out that 80% of the discussion focused on business issues, whatever one board member said to another or said to counsel is not discoverable as it is considered part of a privileged communication with counsel. Thus, if the corporation itself is later in litigation over the sensitive matter discussed by the board in the presence of counsel, the board's discussion of the matter generally cannot be discovered. This makes it more difficult to develop accusations of director misconduct - more difficult for the barbarians to crash in. Exceptions to this would include the case where the board discussed with counsel the planning or continuing of a fraud or crime. The privilege probably would not attach in those circumstances.

Perhaps an ever greater cloak of protection for directors is the use and reliance upon professionals who can include counsel, financial advisers, accountants, or even officers of the company. Most jurisdictions provide that if a board takes action in reliance upon the advice of professionals, it is much more difficult to mount a breach-of-fiduciary-duty attack. Thus, if the director meeting minutes reflect that the board took action in reliance upon the advice of counsel or in reliance upon the advice of an accountant, it is much more difficult to claim the directors breached a fiduciary duty. This is a form of risk-shifting designed for the benefit of directors under most states' laws and which is amazingly underutilized by corporate boards. Going into executive session is also often an underutilized tool. This tool may be more beneficial with large non-profit corpora-

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tions, including health care corporations, where members are permitted to attend all board meetings, including hostile members. The board can retire to executive sessions with counsel. While the board typically cannot take action in executive session, the board members can discuss almost anything and the minutes would only reflect that the board went into executive session. The board can then emerge from executive session and take whatever action deemed necessary.

Then there are the minutes. When it comes to corporate minutes, less is more. Minutes should be sparse and should have virtually no detail of the nature of the discussion.

Minutes recording the discussion of an item on the agenda should be as follows:

“The board next considered the design department’s recommendation of polka dots over stripes. Following a presentation of the issue by Mr. Stripes, there followed a general discussion and the board voted unanimously to accept the proposal.”

There should never be a blow-by-blow of who said what.

The reason for this is simple. Trial lawyers love blow-ups. Even in the most complex

commercial lawsuits involving hundreds of thousands of documents, the most damaging events often turn on one sentence from one document which the lawyers blow up in big letters and show to the jury again and again and again. In the recent Microsoft antitrust trial involving thousands of documents, it was only a handful of documents which did serious damage to Microsoft. And it was then only a handful of sentences within that handful of documents which inflicted untold damage which could result in the break-up of a \$300 billion corporation.

Board members who want every detail of every discussion recorded in the minutes naively believing it will show the thoughtful deliberations of the board simply cannot anticipate every nuance of every subsequent legal battle. They also ignore another problem with detailed minutes - what they might not say. If minutes are so detailed that they record every thought expressed by every board member, they can be used to demonstrate what the board was not considering at the time. It is this failure to consider something which could be the Great Blank Blow-up in the courtroom.

The foregoing is aimed at keeping the barbarians outside the boardroom gates. But the strategy does not end if the barbarians enter the boardroom. Depending upon the scenario presented, there are a number of actions which should be taken in the event one or more board members are named in a lawsuit. When a single member or a minority of board mem-

bers are named in a lawsuit, a firewall should be erected as to the subject of the lawsuit. This allows the rest of the board to consider strategies in response to the lawsuit on behalf of the corporation while the defendant board members can consult with their own counsel. Typically, counsel for the corporation and its board and counsel for the defendant board members would communicate among themselves through the vehicle of a joint defense agreement so that the overall strategy would remain coordinated.

Of course, when any board member is named in a lawsuit, the first person who should be called is counsel and the second person who should be called is the claim’s representative of the D&O carrier. Even if the lawsuit does not assert claims that are covered under the D&O policy, the carrier may still provide defense counsel and may simply reserve its consideration of whether the policy applies to any liability.

In the rare case where all members of the board are named as defendants, a firewall is impractical. Yet, there should be retained separate counsel to represent the board and to represent the corporation. The board’s counsel is typically paid through the D&O carrier. If the D&O carrier insists on hiring counsel itself, the board may want to consider whether it should hire its own counsel to oversee and work with the D&O carrier’s counsel. Whether to do this would depend upon the nature of the action itself. If the lawsuit seeks to recover significant monies and is deemed something more than a frivolous lawsuit, second counsel should be considered.

In the case where all board members are named as defendants, it may also be prudent for the board to delegate supervision of the lawsuit to one or a small handful of board members who can act as the main contact with counsel. This would create an environment where counsel has one point person to whom to report and from whom to receive instructions. This would assist in the development of a cohesive litigation strategy and would diminish the possibility of leaks from the boardroom. Board members should never discuss the litigation among themselves outside of the presence and *cloak* of counsel.

This last decade has seen a remarkable proliferation in both the quantity and quality of business litigation. Plaintiffs who sue corporations are becoming evermore sophisticated in their techniques and theories. What was a frivolous legal position ten years ago may have become meritorious today. Hundreds of courts across the country can reject the same arguments over and over again and all it takes is one judge in one jurisdiction to finally agree with that argument and new precedent is created and the legal landscape shifts. The legal landscape is continually shifting and loss prevention in the boardroom is more important than ever.

The barbarians are always at the gates and will always be succeeded by new generations of barbarians. Good loss prevention techniques not only keep the barbarians outside the boardroom gates, but also provide that in the unfortunate event the barbarians enter the boardroom, there will be nothing for them to find.

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