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Mediating Complex Corporate Disputes Involving Officers and Directors

Claims against corporate officers and directors most commonly are derivative claims brought on behalf of a corporation or LLC in which the company is a nominal plaintiff. These claims allege that the defendants have breached their fiduciary duties of care and loyalty owed the company and its shareholders under state law. However, officers and directors can also be named as defendants in direct claims against the company, most commonly in class actions alleging securities fraud. In this article, I will focus on derivative cases, but many of the concerns will be the same, especially those involving culpability, the level of claims and personal exposure, and insurance coverage.

Mediating derivative claims requires an understanding of the applicable state corporate law; the nature of the claims; the position and defenses of each defendant, including each's indemnification rights and exculpation under the company's charter or operating agreement; the company's view on the merits of the claims; the amount of directors and officers (D&O) insurance coverage, including primary and excess coverage policies; and the possibility of liability of the insureds in excess of policy limits. In the mediation, there will be counsel for the plaintiff, who must be a shareholder (in a bankruptcy case, the plaintiff may be the bankruptcy trustee); counsel for the company and for each of the defendants; and counsel for each of the insurance carriers.

Derivative claims against officers and directors generally are brought by a named shareholder or LLC interest holder (although in Delaware and some other states, creditors can bring the claim if the company is insolvent), but the company is always the nominal plaintiff, and the action seeks to recover for the company. The company, of course, can make decisions and act only through its officers and directors. As an initial matter, the company will normally deny the validity of the claims, but its position as the beneficiary of any recovery must be understood as negotiations for a settlement begin. In addition, there may be tension and disagreement among directors and officers, especially if board members and officers have changed since the time of the alleged wrongdoing.

Similarly, the defenses and positions of each director and officer must be carefully considered. Under current law in Delaware and most states, all can be exonerated from liability for breach of the duty of care in the charter or shareholder agreement, but it is possible that some will not be. If the claims are for breach of the duty of loyalty, they cannot be protected from liability (but they can be exonerated from liability for all fiduciary duties in an LLC operating agreement). Thus, each defendant's relationship as a participant in or beneficiary of the transactions or acts underlying the claim or relationship with a controlling shareholder who benefited must be understood in assessing duty of loyalty issues. Also, some officers and directors may be concerned about negative publicity for the company-and themselves personally-if the case moves forward.

Another factor for the mediator to take into account is the status of the case. Motions to dismiss will have been filed both on whether the complaint has stated valid claims and whether pre-suit demand has been made or excused under the doctrine of demand futility. The demand futility doctrine is closely tied to the potential liability of the defendants. Before a derivative complaint can be filed under state law, the shareholder plaintiff must first make a demand on the board to bring the claim, unless the plaintiff can show that demand would be futile. If demand must first be made, the case is usually dead on arrival because courts do not second-guess a decision by a board that the claim should not be brought. Futility is present when the plaintiff can plead facts showing that the majority of the board is conflicted because of potential liability under the claims or a close personal

relationship with a controlling shareholder. Thus, the statuses of motions to dismiss will have a huge effect on the view of the parties of the value of the claims.

In any derivative case, the status and amount of D&O insurance coverage is of utmost importance, and counsel for the carriers and carrier representatives are key players as they seek to limit the amount of any settlement to be paid from their policies. D&O insurance typically has three levels of coverage: side A, which provides direct coverage to the directors and officers for defense costs and liability; side 8, which reimburses the company for amounts the company pays under indemnification obligations owed to the directors and officers; and side C, or entity coverage, which insures the corporation in its own right for certain claims, such as securities class actions. Issues to be understood include (1) the rate at which the attorneys' fees for the multiple defendants in this case and the fees and exposure in other cases falling under the same policy limits-such as a parallel securities class action-are eroding the coverage; (2) whether the policy could become part of a bankruptcy estate for the company if bankruptcy is an issue; (3) whether the side A coverage has stand-alone coverage; and (4) whether the carrier has denied coverage or reserved rights under policy exclusions. Issues can also arise between the primary and excess D&O carriers. For example, a primary carrier may take the position that it will fund a settlement within the primary policy limits only if the excess carrier contributes some amount, arguing that if the case is not settled, the recovery could easily exceed the primary policy limits and that the excess should have to pay for the elimination of its exposure. Finally, it is also possible that defendants who want to settle within policy limits and are concerned about their personal exposure under a large verdict will consider a bad faith claim against a carrier that will not agree to a settlement number, creating a difficult situation for the defendants' attorneys, who are being paid by the carrier.

A mediator in a derivative case thus confronts a situation with multiple parties and attorneys and a playing field where the battle lines keep changing. An understanding and appreciation of the issues and concerns for all parties and the fact that the issues between defendants themselves, defendants and carriers, and among carriers are fluid, plus the unusual situation of the company, are essential. A mediator with such knowledge and experience is in a position to help the parties reach a resolution that is in the best interests of everyone involved.

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