NEW JERSEY DEFENSE

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President's Message

Mario Delano, Esq.

So, today is the first day of Spring and I am in Bradley Beach, NJ looking at bright sunshine over a sandy beach and surfers on the breaking waves. I am suddenly brought back down to earth when my wife, sitting across the table, comments on the falling snow outside. I am intentionally sitting in one of my favorite lunch spots, with my back to the door so I can look at the surfing mural on the wall, rather than look at the depressing weather outside….more snow. They tell us "Spring is in the air," so let's go with that.

Things have been moving quickly and we have more exciting events planned for the upcoming months. First, in our continuing efforts to "Go Green", our editor, Greg McGroarty is working on having the last paper recipients receive our publication electronically. I would like to thank Natalie Watson, our diversity chairwoman, for her participation in the New Jersey State Bar Association's Diversity Summit. I would also like to thank the State Bar Association for presenting this important program and for inviting the NJDA to be a co-sponsor. By the time you are reading this, our Young Lawyers Seminar will have been held. We plan to have this seminar, providing the basics for newly admitted attorneys, as a yearly event. We are co-sponsoring a Municipal Court seminar with the Hudson County Young Lawyers and the Hispanic Bar Association of NJ Young Lawyers on April 16, 2015 and finally, our ADR committee has a breakfast seminar on April 28, 2015 at The Mansion in Voorhees, NJ. We hope to see all our South Jersey members there.

On January 20, 2015 Natalie Mantell represented us in front of the New Jersey Supreme Court for the hearing in Lippman v Ethicon, Inc. Natalie prepared the Amicus brief on behalf of the NJDA and wrote an article on the case in our Summer 2014 issue.

Our annual convention will be held at the Omni Bedford Springs Resort and Spa in Bedford Springs, PA from June 25 through 28. We will be presenting CLE accredited seminars covering Employment Law, Environmental Law, Products Liability, Workers' Compensation, Appellate Practice, Ethics and our annual Civil Case Law Update. In addition to the amenities already offered at the resort, for a small fee, our members can experience a private cooking demonstration given by the Omni's award-winning culinary team on Friday June 26. Although the convention begins with the 6PM welcome reception on June 25, getting there a day earlier to take advantage of all there is to do at the resort isn't a bad idea. Sign up NOW!

In closing I am taking another look outside my window where the bad weather continues and I think about the 10 or so years in a row that I have seen the Trans-Siberian Orchestra in concert. Echoing in my head is a line from their song What Is Christmas?, "Snow, I don't even like the sound of it." On March 20, 2015, neither do I….

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When Products Liability Begets Directors And Officers Liability

*Joseph Monteleone, Esq.**

This is not an article so much about product liability, as it is about the collateral damage that may be faced by a corporation and its directors and officers in shareholder litigation commenced in the aftermath of and in consequence of a massive product liability exposure.

Perhaps the best illustrative examples emanate from the automobile industry, in particular the now notorious General Motors Company ("GM") ignition switch failures, vehicle recalls and ensuing claims by people allegedly injured or killed as a result of the product defects.

By way of brief background, GM has been hit with a number of product liability lawsuits arising from incidents where an allegedly defectively designed ignition switch moved to the "accessory" or "off" position while the vehicle was being driven, as a result of causes such as weight on the key ring or simply being jostled by a rough road surface. As a result, the driver had difficulty controlling the vehicle and, in cases where the vehicle subsequently crashed, its airbags failed to deploy. In addition to the product liability suits, consumer class actions have been filed by vehicle owners alleging economic loss and claims by injured parties have been filed with a victims' compensation fund before a mediator.

In the midst of all of this, there have emerged two actions filed by GM shareholders. Both actions are pending in the United States District Court for the Eastern District of Michigan.

The first is a shareholder derivative action styled *In Re General Motors Company Shareholder Derivative Litigation*, Case No. 14-cv-11277. A verified consolidated complaint was filed in this action on August 21, 2014 and alleges on the part of various GM executive officers and members of its Board of Directors breaches of fiduciary duty, waste of corporate assets and unjust enrichment.[1] The extent of alleged monetary damage to the company is already in the billions of dollars with $2.7 billion in recall and loaner vehicle costs, and $10 billion at issue in the consumer fraud actions, without even considering the bodily injury claims and damages to the company's reputation and goodwill. A Motion to Dismiss has been fully briefed and the motion is set to be heard on December 17, 2014.[2]

The second suit is a shareholder class action styled *Pio v. General Motors Company et al.*, Case No. 14-cv-11191. *Pio* was filed on March 21, 2014 and remains in its early stages while putative lead plaintiffs and lead counsel jockey for appointment by the Court. This class action is brought on behalf of all GM shareholders who purchased their securities between November 17, 2010 and March 10, 2014. The allegations are that GM and its officers engaged in a scheme to hide from both its customers and investors the fact that its products were plagued with a number of serious safety defects, which were causing vehicle crashes and consequential serious injury and, in some cases, deaths. Allegedly, despite the company's awareness of the problems as far back as 2001, it never initiated any recalls of the vehicles until early 2014. Unlike the shareholder derivative action, the class action confines the defendants to GM and certain officers who are members of its present and past executive level management.

Shareholder suits following on the heels of massive and costly product liability litigation is not a new phenomenon and one need not look any further than the automobile industry for a past and likely future example.

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Prior to the current GM litigation, Toyota Motor Corporation ("Toyota") experienced unintended acceleration issues in many of its vehicles, allegedly due to poorly designed floor mats becoming lodged under the accelerator pedal. Toyota paid a then record $1.2 billion penalty to the U.S. Department of Justice ("DOJ"), but was able to avoid a corporate guilty plea. Ensuing shareholder class action litigation in the U.S. was settled for $25.5 million. The shareholder class was comprised of investors who bought Toyota's American Depositary Receipts ("ADRs"), which were publicly traded on the New York Stock Exchange. To put the settlement in perspective, the negative publicity from the recall campaign and DOJ penalty wiped out as much as $30 billion in Toyota market capitalization. The settlement represents only about 0.08% of that market cap loss.

If there is ghost of Christmas future lurking here, it is with the ongoing Takata Corporation ("Takata") air bag saga, which is of more recent vintage than the GM ignition switch problems. Allegedly defective Takata airbags have been found in a wide range of vehicles manufactured by almost all of the world's major automobile producers, including GM. The company's stock has fared poorly in the face of massive vehicle recalls in Japan and at least one consumer class action brought in the U.S. Note that Japan does not have a class action mechanism similar to the U.S. and recalls in the U.S. are only now being considered. It remains to be seen whether U.S. securities litigation follows, as Takata ADRs are also traded in the U.S.

Turning back to GM, the *Pio* class action is grounded, as are most securities fraud class actions, in allegations of no or inadequate disclosure as to the impact of events, facts and circumstances during the class period on the company's stock performance once the "bad news" is fully revealed at the very end of the class period. As is somewhat typical, the defendants are the company itself and executive level management, in this case including GM's current and former CEO, the company's President and two executive vice presidents.

Interestingly, the company's CFO is not named as a defendant, perhaps because the complaint does not directly allege misrepresentation as to financial data. Somewhat more interesting is the fact that the complaint does not name GM's general counsel, despite the fact that it is replete with allegations as to what the company's law department knew or should have known. Most of the allegations center upon GM touting its vehicles' safety and reliability. Although it remains to be seen what unfolds in the litigation, it would not be unusual for the defendants to file a Motion to Dismiss once the lead plaintiff and lead counsel issues are resolved. That motion will attack the sufficiency of the pleading and will likely raise issues of loss causation, particularly on the basis that statements as to product reliability and safety were very general, non-actionable, and permissible "puffery". The mere fact of a significant stock price decline at the close of the class period is not sufficient, in and of itself, to sustain a viable securities fraud claim. Until this motion practice is concluded, no discovery can take place, a significant benefit to the defendants.

Another key element of establishing securities fraud under the federal securities laws[3] is *scienter*, which must be established by at least reckless conduct. One key element in support of a *scienter* allegation is insider sales by the individual defendants, but none is alleged in *Pio*.[4]

Although not so purely in terms of time, the shareholder derivative actions are much further along, with several individual actions having now been consolidated in the Eastern District of Michigan. As noted above, the next critical event will be the hearing on the Motion to Dismiss set for December 17, 2014. The judge may or may not rule on that motion from the bench that day.

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The key issues in the shareholder derivative litigation at present are the following. First, whether the plaintiffs were justified in not first making a demand pre-suit on the entire GM Board of Directors to take action. The plaintiff's response is that such demand would have been futile in that virtually the entire Board's conduct is implicated thus not "disinterested", and they have each been named as defendants.

Second, as a Delaware corporation, GM has apparently adopted a charter provision pursuant to Section 102(b) (7) of the Delaware General Corporation Law, exculpating its directors from liability for breaches of the fiduciary duty of care. If this defense is successful, the shareholder can only establish director liability through breaches of the duty of loyalty or good faith. These are much more difficult to establish than duty of care violations, although 102(b) (7) only extends its protection to directors, and not to officers of the corporation.

Even more explicit than in the shareholder class action, the derivative litigation contains numerous allegations that the product defects at issue were well-known to GM's legal department long before the recalls took place. As in the shareholder class action, the GM general counsel, is not named as a defendant.[5]

Looking down the road, and assuming *arguendo* that defendants will not prevail upon the Motion to Dismiss, plaintiffs will face a considerable hurdle, as they would in any shareholder derivative suit, that the Board's actions are protected by the "business judgment rule" defense, requiring that the plaintiffs establish at least gross negligence on the part of the Board to overcome the defense. All of the individual defendants named are present or former Board members, although some are also identified as present or former officers of GM. Corporate officers do not necessarily enjoy the same protection under the business judgment rule under applicable Delaware law.

<u>Who Ultimately Pays For All of This?</u>

In product liability litigation, commercial general liability ("CGL") insurance typically covers much of the defense costs, as well as settlement and judgment amounts that may ensue. In the shareholder litigation discussed here, it is typically D&O insurance that will respond.[6]

Although we will not attempt to give anything close to an exhaustive treatment of D&O insurance policy features here, there are a few key points to bear in mind with respect to how D&O differs from CGL insurance and how a D&O policy may respond differently to a shareholder class action, as opposed to a shareholder derivative action.

First, unlike as in the case of CGL insurance, defense costs under a D&O policy are subject to a retention or deductible amount and will erode the available limit of liability. With defense costs in many of these claims running into the tens of millions of dollars, it is not unusual for the primary layer of insurance to be fully exhausted by covered defense costs and then the liability to pay these costs proceeds into the next excess layer.[7]

Second, there are usually three (3) principal insuring agreements under a D&O policy issued to a public company.

- Side A – applies to cover the directors and officers in situations where they cannot and are in fact not indemnified by the company. Typically, these situations occur when the company is financially insolvent or where the company is not permitted to indemnify as a matter of law.

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- Side B – applies to cover the company to the extent it lawfully indemnifies its directors and officers. This is sometimes called corporate reimbursement coverage.
- Side C – applies to cover the company for its own liability and costs of defense, but this coverage is typically limited to "securities claims", which would include the class and derivative actions discussed in this article.

Third, D&O policies are almost always written on a claims-made or claims-made and reported basis. Thus, unlike in the case of occurrence-triggered CGL coverage, there is rarely a situation where a single claim or series of interrelated claims trigger more than one year of insurance coverage. That being said, it is not unusual for large public companies to carry excess D&O limits into the hundreds of millions of dollars for a policy year.

Fourth, the D&O policy may respond differently to a shareholder derivative action than to a shareholder class action. Two important differences are as follows.

- In a shareholder derivative action, the company is typically a "nominal defendant" only, as is GM in this litigation. That means that any monetary recovery will be paid into the corporate treasury, as opposed to the shareholder(s) bringing the suit. That is not to say, however, that the plaintiff lawyers will not potentially be paid a significant fee award to be borne by some combination of the company, the individual defendants and the D&O insurers.
- As a nominal defendant with no wrongdoing alleged on its part, many D&O insurance policies will not cover legal costs incurred by the company to produce documents and otherwise respond to discovery and disclosure requests. These expenses may be sizeable.
- Under Delaware law and the law of most other states, it is not permissible for a company to indemnify its directors and officers for their share of any settlement or judgment amount in a derivative action.[8] This is because the law seeks to avoid "circularity" in any payment by the directors and officers, only to have them indemnified for their payments by the corporation. The D&O insurance implication of this is that these derivative settlements and judgments will be paid under the Side A insuring agreement. That is significant because there is usually no retention amount under Side A of the policy, and there is often a separate "tower" of Side A only D&O insurance that sits on top of the traditional D&O coverage and could well be implicated in the case of a large settlement or judgment.

END NOTES

[1] None of these counts is spelled out in great detail in the pleadings, but the breach of fiduciary duty is essentially one of care that is owed to the corporation to manage its business effectively and efficiently. The waste of corporate assets is presumably the exacerbated monetary costs to GM as a result of not timely identifying the product defect and recalling the vehicles for corrective action. The unjust enrichment count is also confusing in that no insider sales activity is alleged. However, the complaint sets forth in detail the individual defendants' compensation levels during the years at issue. As such, it is possible that will be later fleshed out to sustain an allegation that they ignored the problem in order to entrench themselves in their positions and perhaps enhance the value of any GM stock options they may have held.

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[2] Linder Sandler, *GM Nine-Month Recall Costs Total $2.7 Billion on Repairs*, Bloomberg News, October 27, 2014, www.bloomberg.com/news/2014-10-27.

[3] The key federal laws in this regard are Section 10 (b) of the Securities Exchange Act of 1934 ("the Exchange Act") and Rule 10b-5 promulgated thereunder.

[4] In Pio, the individual defendants are also alleged to be liable on the basis that their executive positions made them "controlling persons" for purposes of Section 20 (a) of the Exchange Act.

[5] This may be the case for numerous reasons, including the fact that the derivative allegations are grounded in breaches of director's fiduciary duties.

[6] The author is not aware of the extent of D&O insurance, if any, in force for GM and specifically whether and how it may apply to the litigation discussed here. His commentary is based upon D&O insurance in general.

[7] Note also that D&O policies for public corporations are not typically written with a duty to defend, only an obligation to pay defense costs. As such, once its limits are exhausted – even if only by payment of defense costs – that insurer has no further payment obligations, including payment of any settlement or judgment amount, under its policy.

[8] This same prohibition, however, does not usually apply to advancing their defense costs.

*** Joseph Monteleone is a Partner in Rivkin Radler's Directors & Officers Liability and Insurance Coverage & Litigation Practice Groups. Joe represents insurers in coverage litigation, regulatory matters, and arbitrations. He also provides coverage advice and monitoring of underlying litigation in the areas of professional liability, errors and omissions ("E&O"), directors and officers ("D&O"), employment practices liability ("EPL"), and other claims-made insurance products. He currently is a vice chair of the Professional, Officers and Directors Liability Committee of the American Bar Association.**