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**D'AMATO
& LYNCH**

FIRM PROFILE

George G. D'Amato founded the firm in 1969. On October 1, 1977 Luke Lynch, Sr. (1921-1999) joined as a named partner to establish the present day law firm. Since its inception the law firm has built its reputation as a leading law firm in the insurance and financial communities. Because of the firm's commitment to ingenuity and efficiency, the law firm has grown from only four attorneys when it was created over a quarter of a century ago, to close to 100 partners, counsel and associates in 2001.

Over the years, D'Amato & Lynch has become a leader in the area of directors/officers and professional liability. As the financial community became more interrelated, the practice expanded into financial and banking transactions on both a both domestic and international level. The firm's extensive litigation experience includes representing clients at the trial as well as appellate levels of state and federal courts.

D'Amato & Lynch's overall experience in directors and officers matters has allowed the firm to grow into one of the largest law firms in this field. D'Amato & Lynch represents insurers in connection with class action and derivative actions brought against the management of major companies. These actions frequently involve the Fortune 100 companies and often involve exposures of hundreds of millions of dollars. Our partners are directly engaged in the negotiation of major settlements.

The firm has defended securities class action litigation and has defended specialty cases under directors and officers policies issued to financial institutions, for-profit corporations, not-for-profit corporations, municipalities, universities, cooperative and condominium associations and boards, investment bankers, security agents and brokers, general partnerships, as well as ERISA claims, among others.

The firm's offices are located at 70 Pine Street, New York, New York 10270-0110 and One Lime Street, London EC3M7HA, England. The law firm has a staff of over 150 professional staff and employees. The general telephone number at the law firm is (212) 269-0927 and the fax number is (212) 269-3559.

**D'AMATO & LYNCH
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**DIRECTORS' AND OFFICERS' LIABILITY
IN THE UNITED STATES OF AMERICA**

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1 Structure of Corporate Entities in the United States

Corporations are usually created under general corporation laws of the state in which incorporation is sought. Unlike many other countries, the United States has not adopted national legislation covering corporate formations and/or governance except in limited circumstances. The exceptions are relatively few and include those for banks and savings institutions, which may be nationally chartered. A firm may incorporate in any of the fifty states. A corporation's internal affairs are governed by the law of its state of incorporation. Corporations must then qualify to do business in the other states where it conducts business on a regular basis. Delaware state law is considered the leading authority in business corporation law due to the great number of corporations that choose to incorporate there.

A corporation may be:

Publicly Held: corporation with shares outstanding that are held by public investors, as opposed to owner-managers and their affiliates.

Privately Held or Close Corporation: corporation that is owned by relatively few people, usually management or family members who actively manage; there is no public market for its stock, the transferability of which is in many instances limited.

2 Who are Directors and Officers?

Directors are generally defined as those individuals who are elected either by the incorporators or by shareholders, usually at an annual meeting, and who are empowered to carry out certain tasks enumerated in the corporation's charter, articles of incorporation, or by-laws. Among such powers are: appointing senior management, naming members of executive and finance committees, issuing additional shares and declaring dividends.

Officers are individuals selected by the board of directors, which prescribes their duties and fixes their compensation. The corporate by-laws and resolutions passed thereunder define the types of officers who may be appointed as well as the scope of their responsibility. Officers are typically charged with the daily management of the corporation's policies and affairs. Officers normally include a president, one or more vice presidents, a secretary and a treasurer. Minor officers such as assistant treasurer or assistant secretary may also be appointed by either the board or by the chief executive officer.

3 Legal Basis of Directors and Officers

A. Statutory, Civil or Contractual Legal Framework

The state law in which a corporation is chartered controls the requirements necessary to confer the capacity of a director or officer upon a person. Generally speaking, the state law will state that a corporation's charter can set out how officers are appointed. The corporation's charter will usually provide that the board of directors appoints the officers.

B. Duties and Requirements of Directors and Officers

In addition to stating the requirements to become a director or officer, the law of the state of incorporation will also specify duties that directors and officers owe to their corporations as well as the ability of the corporations to indemnify their directors and officers. In addition, directors and officers may be personally liable under the federal or state laws that regulate the business activities of the corporation.

Examples of duties imposed by federal statutes regulating the business activities of the corporation are as follows:

Securities Act of 1933: This statute imposes liability upon directors and officers for material misstatements or omissions in registration statements filed with the Securities and Exchange Commission.

Section 10b of the Securities Exchange Act of 1934: Directors and officers are liable for fraudulent misstatements or omissions of material fact relied upon in connection with the purchase or sale of securities or other public statements, if they acted with the required *scienter* (i.e. participated in or had knowledge of the fraud or if their lack of knowledge resulted from willful or reckless disregard of the truth).

Other examples of statutorily imposed duties are discussed below in Section G.

C. The Business Judgment Rule in the United States

Under the business judgment rule directors and officers are not liable for good faith business judgments that turn out poorly, provided that they have been reasonably diligent in making an appropriate investigation before making the decision. Directors are entitled to rely in good faith on information provided by officers, other board members, employees and outside professionals, but will generally be held liable to their corporations for gross negligence.

D. Duties of Directors and Officers Towards the Corporation

Generally speaking, directors and officers owe a duty of care and a duty of loyalty to their corporations.

i. Duty of Care

State statutes typically provide that a director or officer must discharge his/her duties to the corporation with such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances (roughly half of the statutes refer to officers as well as directors). The trend is for state statutes to provide that a director or officer will be liable only in cases of gross negligence. Directors and officers fulfill their duty of care when they exercise good faith business judgment in the best interests of the corporation.

A director usually cannot invoke the business judgment rule if he/she causes the corporation to engage in acts that are illegal or contrary to public policy and will be liable for any loss sustained by the corporation as a result. A director may also be liable for the acts of other officers and directors, but only if: he/she participated in the acts; was grossly negligent in failing to discover the misconduct; or was grossly negligent in appointing the wrongdoer.

ii. Duty of Loyalty; Conflict of Interest

Duty of loyalty and conflict of interest laws also vary among the individual states. However, in all states, directors and officers are held to a duty of loyalty in all dealings with the corporation, i.e., a duty to promote the interests of the corporation without regard for personal gain and to avoid conflicts of interest. Usually special procedures must be followed where directors have an interest in a transaction. For example, under Delaware law, interested director transactions are not voidable for conflict of interest if: (i) the material facts as to the director's interest and the transaction were fully disclosed or known to the board and the transaction was nonetheless approved in good faith by a majority of the board; (ii) the same information was disclosed or known to shareholders and a majority of the shareholders approve; or (iii) the transaction is substantively fair to the corporation.

E. Duties of Directors and Officers Towards Majority and Minority Shareholders

As noted above, directors and officers owe fiduciary duties to all shareholders. These duties include: (i) the duty of good care and (ii) the duty of loyalty, which in turn includes the duty of good faith.

In the context of a sale, merger or acquisition, some courts have held that the directors and officers are: (i) required to act in good faith concerning the corporation's affairs; (ii) required to put the corporation's interests ahead of personal interests; and (iii) required to not misrepresent the financial status or operations of the corporation to its shareholders. In such situations, directors of the acquired corporation are generally obligated to do what is in the best interest of the shareholders, which may include seeking the best share value reasonably available. There is no strict method for determining the best share value reasonably available.

To protect minority shareholders' rights, some courts have held that when majority shareholders decide to acquire the remaining shares of a corporation, the directors have a duty to the minority shareholders to assess the proposed transaction and to make an independent determination of whether the transaction will maximize value for its minority shareholders.

F. Duties of Directors and Officers in Case of Insolvency or Bankruptcy

Generally, directors and officers owe no fiduciary duties to the corporation's creditors. Creditors' rights are protected by the terms of the contract and under debtor-creditor law. However, courts have held that directors' and officers' fiduciary duties expand to include duties towards their creditors when a corporation: (i) is in the "vicinity" or "zone" of insolvency (defined as when a corporation's liabilities exceed its assets or when a corporation is unable to pay its debts); or (ii) is near bankruptcy. Prior to this, shareholders own the corporation and the directors and officers owe fiduciary duties toward these corporate owners. When a corporation reaches the "vicinity" or "zone" directors have the duty to protect the corporate assets in order to maximize the amount of assets available for the creditors.

When a corporation petitions for bankruptcy, the directors and officers maintain the expanded fiduciary duties as required when a corporation reaches the "vicinity" or "zone" of insolvency. Unless a trustee is specifically appointed by the bankruptcy court, the corporation becomes a "debtor in possession" and the directors and officers become the trustee of the corporate property for the creditors' and shareholders' benefit.

G. Status of Enforcement of Directors' and Officers' Liability with Respect to Tax, Labor and Environmental Regulations

i. Tax

Directors and officers of corporations may face both civil and criminal liability for tax evasion and other tax offenses including situations in which a corporation fails to pay appropriate employee withholding taxes.

ii. Labor

Directors and officers may be liable for violations of certain statutes relating to labor and employment. For instance, under the Fair Labor Standards Act, which covers the payment of overtime as well as the minimum wage, any director or officer with corporate control may be liable for damages. This is also the case under the Family and Medical Leave Act, which requires corporations to provide time off to employees for childbirth, to help sick parents, spouses or children and to recover from serious injury.

iii. Environment

Courts have held that liability under the two main environmental statutes (CERCLA and RCRA) applies to directors and officers. CERCLA, commonly known as Superfund, makes corporate polluters strictly liable for all pollution related damage that they caused to the environment. RCRA governs the manner that corporations generate, transport and store hazardous waste.

H. Directors' and Officers' Criminal Liability

Criminal liability for directors and officers has increased greatly over the last twenty years and will continue to increase at an even greater pace. Good examples of this trend involve the enforcement actions filed against the executives of Waste Management and Cendant Corporation.

Further examples of directors and officers being held criminally liable are found in the areas of price fixing and anti-trust violations. Recently, Alfred Taubman, former Chairman of Sotheby's, was convicted of price fixing. Another area of liability exposure is under the False Claims Act where individuals can be held criminally liable for wrongful certification of the worthiness of products delivered pursuant to contracts with the United States government.

4 Statute of Limitations

A. Shareholders' Actions

The statute of limitations for violations of Section 11 of the Securities Act of 1933 is one year after the discovery of the untrue statement or omission. In no event may a Section 11 action be brought more than three years after the securities were offered to the public.

The statute of limitations for violation of Section 10b of the Securities Exchange Act of 1934 is one year after discovery of the facts constituting the violation and within three years after such violation occurred.

B. Contractual Disputes

There is no federal statute of limitations for actions for breach of contract. Each state has its own statute of limitations for such a cause of action. For instance, New York has a six year statute of limitations for breach of contract.

C-D. Discrimination Actions; Sexual Harassment Actions

Title VII, a federal statute, prohibits discrimination in employment on the basis of race, religion, or gender. It also prohibits sexual harassment in the work place. Title VII creates an administrative framework that potential plaintiffs must comply with before they can file a lawsuit against their employer. Pursuant to Title VII, an individual must file a charge of discrimination with the Equal Employment Opportunity Commission (the "EEOC") within 180 days of the date of the act of discrimination or sexual harassment. If the individual does not file a charge of discrimination with the EEOC within this time period the individual will be barred from filing a Title VII action against his/her employer. In the majority of cases, the EEOC decides not to take any action on the individual's behalf and will notify the individual of this fact in writing. The individual has 90 days from receipt of this letter to file a lawsuit against the individual's employer. After 90 days the individual is prohibited from filing a complaint alleging a violation of Title VII.

E. Wrongful termination actions

Generally speaking, private sector workers in the United States are considered "at-will" employees. Therefore, in the absence of a contract, an employee may be fired for any reason except one that violates public policy such as that which is set out in Title VII or other statutes. As such, there is no independent claim for "wrongful termination."

F. Fraud

The most far-reaching federal statute prohibiting fraud is the Racketeer Influenced and Corrupt Organizations Act ("RICO"). RICO was originally designed to serve as a tool to prosecute organized crime. RICO's scope has expanded to the point where it covers fraud in business and securities transactions and other types of "white-collar" criminal activity. The statute of limitations for RICO prosecutions by the United States government is five years. The statute of limitations for civil RICO actions is four years.

With the exception of RICO, there is no federal statute of limitations for fraud claims, however, each state has its own statute of limitations provisions for fraud. The statute of limitations for claims based on fraud in New York is the greater of either six years from the wrong or two years from when the wrong could have reasonably been discovered.

G. Tax

There are different statutes of limitations for different sections of the Internal Revenue Code. For example, Section 6502 of the Internal Revenue Code has a ten year statute of limitations during which the government must recover taxes after they have been assessed. Further, each state has its own revenue code with its own statute of limitations.

5 Who Can Sue?

A. Lawsuits by Corporations Against Their Directors and Officers

Corporations are entitled to sue their directors and officers for breach of duties owed to the corporation. Such lawsuits are rare as compared to shareholder derivative lawsuits but tend to be quite severe as they are brought in only egregious situations.

B. Shareholders

Shareholders of public corporations can bring lawsuits against the corporation's directors and officers in the form of shareholder derivative lawsuits and through class action securities litigations.

i. Shareholder Derivative Actions

Shareholder derivative actions allow shareholders of a corporation to sue the management of the corporation for damage done to the corporation. There are two different types of derivative lawsuits. The first is a lawsuit by a shareholder against the corporation's directors and officers alleging mismanagement. The corporation is named as a nominal defendant. Shareholders are the biggest source of derivative lawsuits. Because of the protection afforded by the business judgment rule it is rare that these lawsuits result in significant judgments.

The second type of derivative lawsuit is when a shareholder sues the directors and officers seeking a judgment compelling the corporation to take certain action to enforce the corporation's rights. An example of this would be a derivative lawsuit seeking a judgment compelling the corporation to sue a third party. In this type of action, the shareholder

brings a lawsuit alleging that the corporation is sleeping on its rights and seeks to force the corporation to enforce its rights.

ii. Shareholder Class Action Lawsuits

The United States has long recognized the ability of a single shareholder to commence a class action securities lawsuit against a corporation and its directors and officers. These lawsuits allege that the corporation and/or its directors and officers made misrepresentations and/or omissions about the well being of the corporation that harmed investors. Private causes of action are authorized under the Securities Act of 1933 and the Securities Exchange Act of 1934.

In order to establish a class of such investors, plaintiffs must meet the five requirements of Rule 23 of the Federal Rules of Civil Procedure. Rule 23 requires that the potential claimants be so numerous that joinder of plaintiffs is impracticable and that there are common questions of law and fact to all plaintiffs. The third requirement is that the plaintiffs' claims are typical in that they arise from the same event or course of action that gives rise to the claims of all members of the class. The fourth requirement is that the class representative must fairly and adequately protect the interests of the class. The final requirement is that a class action lawsuit is superior to the other available methods for resolving the controversy. Courts have long held that class action lawsuits are appropriate vehicles for litigating shareholder lawsuits.

In 1995, due to concern that shareholder class action lawsuits were reaching epidemic proportions, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The PSLRA was designed to make it more difficult for plaintiffs to maintain securities class action lawsuits against issuers and underwriters of securities. The PSLRA requires plaintiffs to meet a heightened pleading standard and makes it easier for issuers and underwriters to dismiss plaintiffs' lawsuits. The PSLRA also provides additional protections to issuers of securities regarding forward-looking statements. To date, the PSLRA appears not to have had an impact in stemming the number of securities class action lawsuits. According to a study, in 1994 and 1995 prior to enactment of the PSLRA, 231 and 188 shareholder class actions were filed while in 2000 and 2001, 216 and 487 were filed. Many of the lawsuits filed in 2001 are "laddering" claims in which issuers and investment banks have been sued in connection with alleged pre-arranged trades at agreed to prices of stock soon after its initial public offering.

The PSLRA also provides that the shareholder with the largest holdings in the action is to be appointed the Lead Plaintiff. As a result of this

provision, large institutional investors and pension fund investors have become more active in managing securities class actions.

Prior to the passage of the PSLRA, the average settlement of a securities class action lawsuit was \$7.8 million and, excluding the Cendant Corporation's settlement, the average settlement after the PSLRA was \$14.4 million. It has also been reported that the average time to settle a securities class action lawsuit takes 2.3 years.

C-D. Creditors and Third Parties

As discussed above, directors and officers owe fiduciary duties to the corporation, not to creditors and third parties. Generally speaking, the rights of creditors and third parties are limited to those set out in their contracts with the corporation or in situations where the corporation is in the vicinity of or in bankruptcy.

E. Insolvency Administrations/Trustees in Bankruptcy

When a corporation files for bankruptcy the trustee, not the shareholders or creditors, is allowed to bring a claim against directors and officers for breaches of duties owed to the corporation including those which resulted in the bankruptcy. With court approval, such claims can also be perused by creditors' committees or by litigation trusts set up under reorganization plans. These claims are usually very severe.

F. Regulatory Authorities for Capital Markets and Labor

i. Capital Markets

The United States capital markets are regulated by the Securities and Exchange Commission (the "SEC"). The SEC was established in 1934 in the wake of the stock market crash of 1929 and is charged with administering the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940. The SEC has widespread authority to regulate all matters related to the purchase or sale of securities in the United States. The SEC also reviews all information disseminated by publicly traded corporations to their shareholders. Publicly traded companies may have more contact on a consistent basis with the SEC than they do with any other government agency.

The SEC has the power to bring civil or criminal lawsuits against corporations as well as against individual directors, officers and employees. In these lawsuits, the SEC may obtain the disgorgement of all ill-gotten gain, may impose fines on individuals and companies and may prohibit individuals from working in the securities business. The SEC brings between four and five hundred civil enforcement actions a year

against individuals and corporations that violate securities laws and regulations. In the 1980's, the SEC along with the Department of Justice garnered much publicity for a series of successful criminal prosecutions against high profile individuals such as Ivan Boesky and Michael Milken who engaged in insider trading. Most recently, the SEC fined CSFB \$100 million for its involvement in the "laddering" transactions in the initial public offering of issuers' stock during 1999 - 2000. A SEC investigation of a corporation is a serious matter and investors tend to become unsettled when it is disclosed that the SEC is investigating a corporation.

The various states also have power to regulate capital market activity although they usually are not very active.

ii. Labor

In the United States, the labor market is not heavily regulated and there are few government regulations relating to the hiring and firing of employees. However, corporations cannot make employment decisions based on the criteria set out under Title VII. Furthermore, the United States Department of Labor regulates many disparate areas related to the work force and working conditions of United States citizens. For example, the Department of Labor is responsible for the following:

1. Ensuring that employers comply with the Fair Labor Standards Act;
2. Administering the Occupational Health and Safety Act to ensure that working conditions are safe for employees;
3. Regulating pension or employee benefit plans that employers offer to their employees;
4. Regulating organized labor and its membership including overseeing union elections;
5. Administering worker training and worker placement programs; and
6. Collecting and analyzing economic statistics.

The Office of Solicitor of the Department of Labor may bring a lawsuit on behalf of the Department of Labor against corporations and other entities that are violating its rules. These lawsuits, however, are fairly uncommon and the usual recourse if a corporation does not follow the rules set down by the Department of Labor is for the aggrieved individual to file a private lawsuit.

The EEOC is charged with administering Title VII and other employment related statutes. The EEOC investigates charges of discrimination that employees file with it and may take action on the employee's behalf. The EEOC has the ability to bring a lawsuit or take other action on the

employee's behalf. The EEOC may also initiate litigation on its own and has obtained significant settlements from large corporations for violations of employment laws. The EEOC may also implement regulations concerning the employment statutes that it enforces.

Every state has its own Department of Labor that regulates issues related to employers and employees on the state level. These state Departments of Labor have a wide array of powers to regulate corporations.

G. Employees

For a description of how and under what circumstances an employee may sue his/her employer see Section 4(C) above.

Employment related claims, which include claims for discrimination based on race, religion or gender as well as claims for sexual harassment, increased greatly over the course of 1990's. It has been reported that in 1990, 8,413 employment lawsuits were filed in federal court while 23,735 were filed in 1998. The number of sexual harassment lawsuits has skyrocketed since 1985. It has been reported that in 1985 only 9 sexual harassment allegations were filed with the EEOC while 4,783 sexual harassment allegations were filed in 1999.

The amount of damages that plaintiffs have recovered in employment discrimination lawsuits has also increased. Reportedly, in 1993 the median recovery for a plaintiff was \$62,000; this amount increased to \$137,000 in 1998. Between 1990 and 1998 the percentage of judgments in employment cases exceeding \$10 million increased from 1.4% to 10.6%.

The number of class action lawsuits alleging employment violations in federal court reportedly increased from 68 in 1996 to 85 in 1998. It is usually difficult for plaintiffs to maintain class action lawsuits against employers as most employment lawsuits are case sensitive and as such are not conducive to being resolved via a class action lawsuit.

6 What is the Enforceability of a Foreign Judgment on Directors and Officers?

Currently, in regards to the recognition and enforcement of foreign judgments in civil and commercial matters, the United States is not a party to an active international convention and is not a signatory to a treaty with another country. The Hague Conference on Private International Law is currently addressing a new multilateral treaty regarding international jurisdiction and foreign judgments in civil and commercial matters, which may include the United States as a signatory. However, at the moment, the recognition and enforcement of foreign judgments

in the United States will depend upon the law of the state where enforcement is sought.

In the United States, generally state law recognizes the principles of comity and reciprocity in connection with enforcement of foreign judgments. Courts will generally look to see whether the foreign court: (i) maintains an impartial judicial system; (ii) has compatible due process of law procedures; or (iii) had appropriate jurisdiction over the defendant originally.

7 Under United States Law, Can the Directors and Officers be Liable for Punitive Damages and Are Punitive Damages Insurable?

Generally speaking, directors and officers may be liable for punitive damages if the statute at issue allows for the recovery of punitive damages. Plaintiffs may recover punitive damages under Title VII if their employer acted with malice or reckless indifference to the employee's rights. These damages can be significant in employment discrimination and sexual harassment lawsuits, but are not recoverable under the Securities Act of 1993 and the Securities Exchange Act of 1934.

In order to recover punitive damages against a corporation and its directors and officers, generally shareholders must prove more than a breach of fiduciary duty. They must establish that the directors, officers or corporation committed malice, fraud or oppression.

8 Under United States Law, Can the Corporation Indemnify its Directors and Officers?

State statutes govern the extent to which a corporation is permitted or required to indemnify its directors and officers for actions taken by them while acting in their official capacities. In some states, reimbursement is discretionary with the board of directors. However, under many statutes, indemnification is mandatory when the director or officer is successful on the merits of his/her defense. Statutes vary significantly as to whether the corporation is required or permitted to indemnify its directors or officers in situations where they lose or seek to settle the lawsuits. The situations in which corporations cannot indemnify their directors and officers usually include findings of willful misconduct.

9 Is Directors' and Officers' Insurance Legal?

Corporations are authorized and even encouraged to purchase directors' and officers' insurance to protect the corporation and its directors and officers against

liabilities arising out of their service to the corporation. However, there are statutes as well as court decisions that provide that some conduct, such as intentional wrongful acts, is uninsurable.

There is no requirement that a directors' and officers' insurance policy be issued by a locally admitted insurer. Premiums on policies issued by unadmitted insurers may be subject to taxes.

In the absence of a policy specifically segregating a premium to a company incorporated in the states, there are no local premium tax consequences.

10 General Comments

Despite increasing efforts to curb shareholder securities litigation, lawsuits against corporations and their directors and officers are continually on the rise. Many of these lawsuits are based on federal securities laws and other statutory schemes; others stem from common law tort claims such as fraud or gross negligence. There is also an increasing call from the investing public for there to be more accountability and disclosures by corporations and their directors and officers. As a result of and despite the protections afforded by the *business judgment rule*, there is an increasing need for directors and officers to protect themselves from personal liability that they may face as a result of these lawsuits.

This article should not be considered as a substitute for specific competent legal advice in a particular case but rather it is provided as general information ONLY.
