



How to Prevent, Prepare for, and Deal with Law Suits that Target Officers and Directors

May 18, 2010

Presentation to the
National Association of Corporate Directors

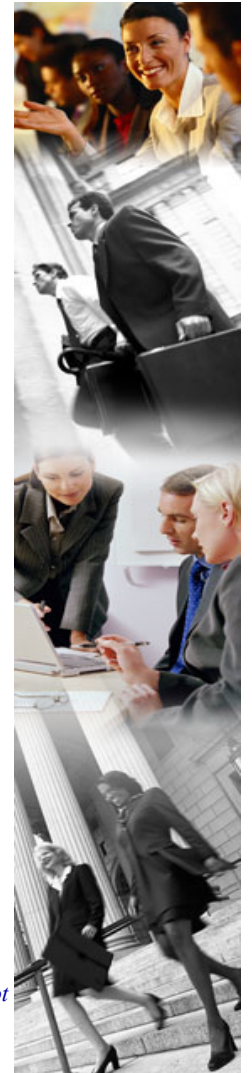
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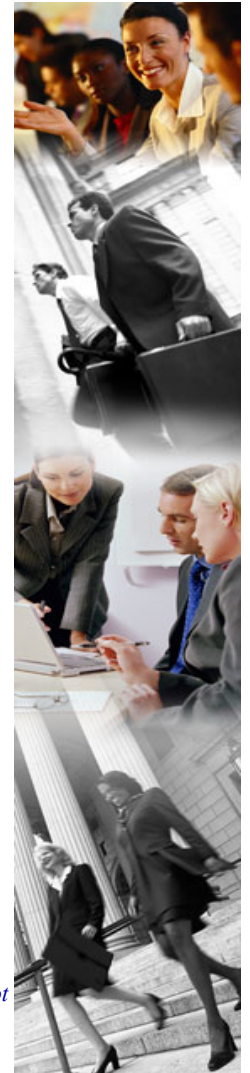
TOPICS TO BE ADDRESSED

- Director Duties
 - Care – Loyalty (Good Faith)
 - Independence – Oversight – Risk Management
- Director Protection
 - Statutory
 - Delaware General Corp. Law Sec. 145(C), Sec. 102(B)7
 - Corporate
 - By Laws
 - Mandatory Indemnity – Advancement of Expenses
 - Indemnity Contracts



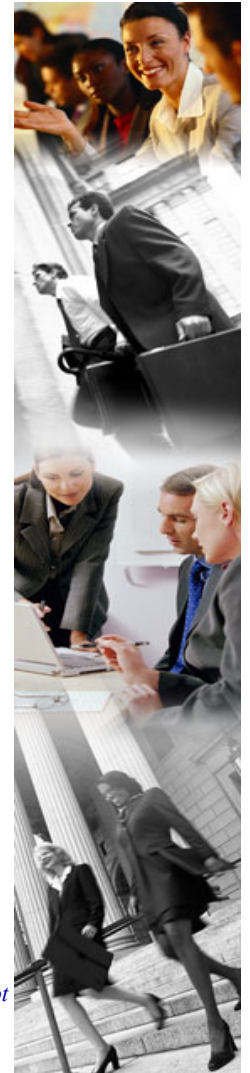
TOPICS TO BE ADDRESSED

- Director Protection
 - D&O Insurance
 - Side A with Difference in Conditions Policy
 - Claims Coverage – Definitions
 - Investigations (Including Internal)
 - Insured v. Insured
 - Company (Derivative) v. Individual
 - Bankruptcy Exclusion – Priority
 - Severability
 - Conduct Exclusions
 - Application
 - Exclusions
 - Fraud – Criminal Activity – Personal Profit
 - Final Adjudication v. In Fact
 - Mergers – Sale
 - Run Off
 - Tail Coverage



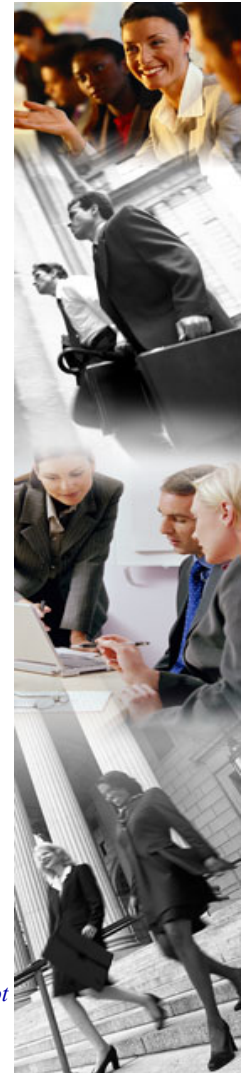
TOPICS TO BE ADDRESSED

- Director Action
 - Record Retention
 - Litigation Hold
 - Criminal Statutes
 - Investigations
 - Overview
 - Mandatory v. Voluntary
 - Initial Determination
 - Role of Chief Legal Officer
 - Factors to be Considered
 - Who Should Investigate
 - Perils of Mishandling
 - Who is the “Client” – Reporting
 - When Does it End?



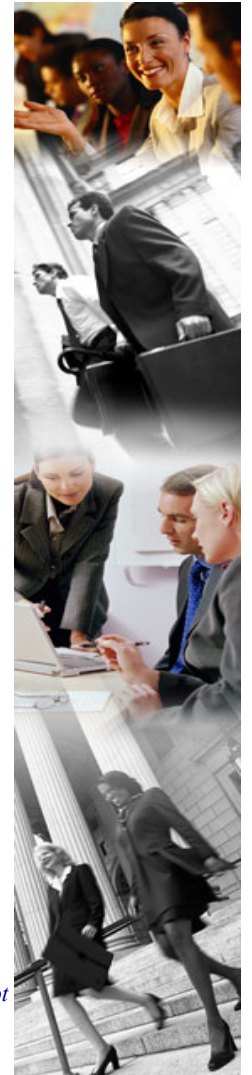
TOPICS TO BE ADDRESSED

- Director Action (continued)
 - Demand by Shareholder
- Refused v. Excused
 - Special Litigation Committee
 - Composition – Independence
 - Diligence – Interviews – Meetings
 - Objectivity v. Attack Claim



TOPICS TO BE ADDRESSED

- Pre-Trial
 - Jury Surveys
 - Mock Trials
 - Preparation
- Trial
 - Theme
 - Technology
 - Trial Graphics
 - Cost of Litigation v. Cost of Losing
 - Realistic Settlement Considerations



DIRECTOR DUTIES

- In times of financial crisis, corporate directors and officers are increasingly targeted as defendants in commercial litigation, in order to access their D&O insurance policies.
- There are emerging theories of liability that attempt to broaden the exposure of D's and O's. But recent Delaware decisions have restricted these theories.



DIRECTOR DUTIES

➤ Who can sue corporate directors for their breach of fiduciary duties?

- Shareholders: Anyone who owns an “interest” in a private or public company.
- And also (sometimes) creditors: But only when companies are “insolvent” which, as a matter of law, is loosely defined.



DIRECTOR DUTIES

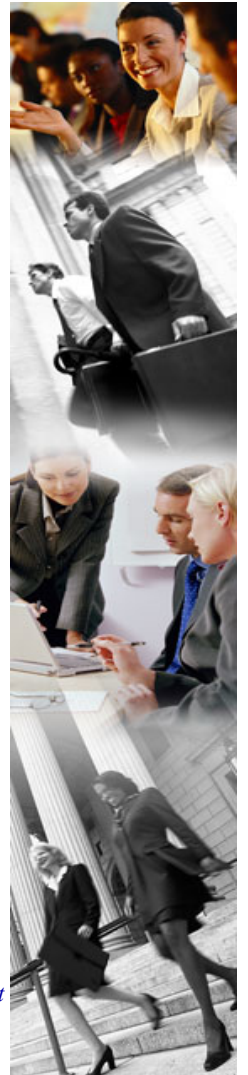
➤ **Under Delaware Law, and in virtually every other jurisdiction in the US and internationally, the directors of a corporation have a fiduciary relationship with the corporation and are responsible for the overall direction and management of the company. For more than a century, the Delaware General Corporation Law and the Delaware Courts have evolved a well-developed and contemporary framework of this fiduciary law.**



DIRECTOR DUTIES

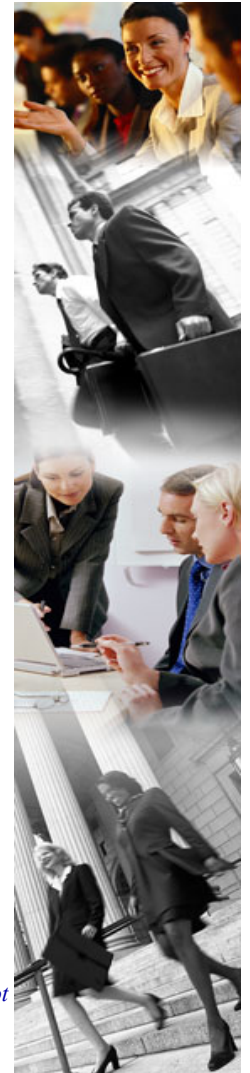
➤ **Three principal duties of directors are derived from Delaware fiduciary law:**

- The Duty of Care
- The Duty of Loyalty
- The Duty of Good Faith
(now considered part of Duty of Loyalty)



DIRECTOR DUTIES

- **The duty of care focuses on the decision-making process, not the resulting decision.**
- **It requires that directors' decisions must be:**
 - Disinterested and independent
 - Well informed
 - Made with a good faith belief that they are in the best interest of the company
 - Formed on the basis of genuine deliberation
 - Based on the expert advice of legal or financial experts, if needed
- **The duty of care requires:**
 - Systems that discourage/detect fraud and wrongful conduct
 - A properly functioning information and reporting system



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DIRECTOR DUTIES

- **The duty of good faith/loyalty prohibits:**
- Self-dealing
 - Misappropriation of company assets or opportunities
 - Conflicts of interest
 - Profiting from a transaction that is not substantively “fair” to the company
 - Transactions in which a director is not “independent”, which in this context means not beholden to, affiliated with, under the influence of, or dominated or controlled by, another party with an interest in the transaction

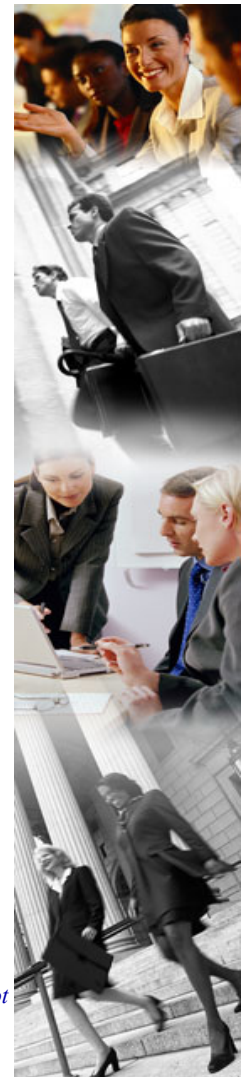


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DIRECTOR DUTIES

➤ The Business Judgment Rule protects directors from liability:

- it presumes that directors act properly and places the burden of proving otherwise on the party claiming wrongdoing
- it recognizes that directors should not be required to insure that every potential corporate problem is anticipated or every instance of wrongdoing prevented
- it provides a safe harbor for directors and protects them from liability where decisions are a result of an informed, deliberative decision-making process and the decision is made in good faith

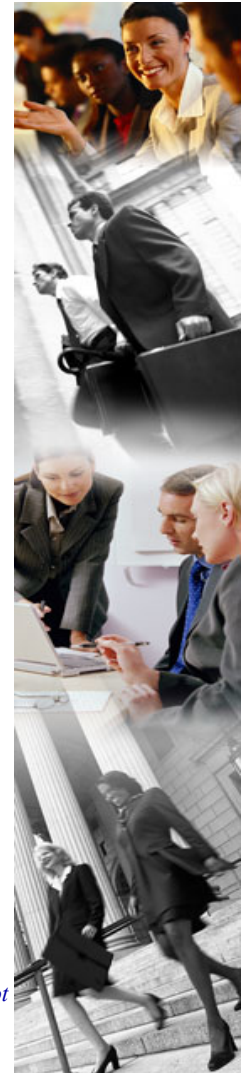


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DIRECTOR DUTIES

➤ The Business Judgment Rule is process oriented, not result oriented:

- it addresses the fairness of the decision-making process, not the quality or outcome of the decision
- it requires reasonable preparation, i.e., directors must make a reasonable effort to inform themselves
- it requires a process that considers all material facts that are reasonably available and is reasonably deliberative, e.g., process cannot be conducted with undue haste or serve as a “rubber stamp”
- keep detailed minutes of the subject matter discussed at the committee and board meeting
- the minutes should demonstrate the length and depth of the deliberative process



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DIRECTOR DUTIES

- **Directors can lose the protection of the Business Judgment Rule and the exculpatory provisions in their corporate charters:**
- If they act in bad faith, ignore a known duty to act or are disloyal. In order to avoid liability, directors must then prove that the decision at issue is entirely fair to the company and to its shareholders

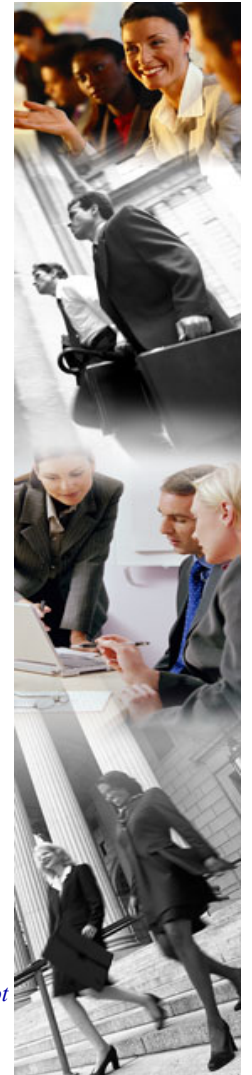


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DIRECTOR DUTIES

Board Oversight

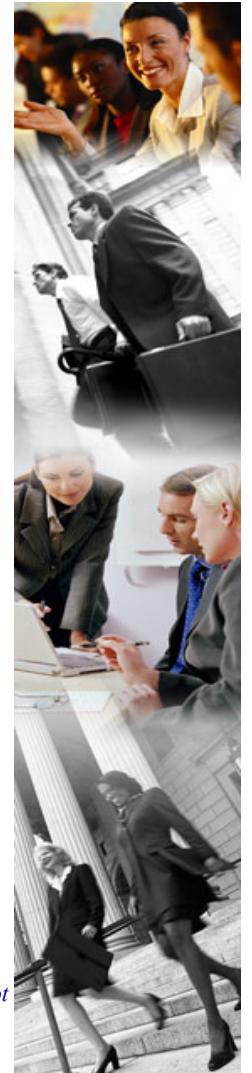
- Since 1996, plaintiffs have been advocating the theory of “oversight fiduciary duty” as a means to avoid the protections of the Business Judgment Rule and corporate charter exculpatory provisions.
- Oversight liability -- in very limited situations -- can form the basis for a breach of a director’s duty of loyalty, even in the absence of any evidence of self dealing, dishonesty, disloyalty or other conduct traditionally required to find bad faith.



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DIRECTOR DUTIES

- **Distinguishing between the duty of loyalty or the duty of care has important, real-life significance.**
- **Directors who breach only their duty of care can be immunized from monetary liability by their corporate charter and by the Business Judgment Rule. However, directors who breach their duty of loyalty lose both those protections.**
- **“Oversight liability” provides the opportunity for plaintiffs to try to put a round peg (breach of care) into a square hole (breach of duty of loyalty).**



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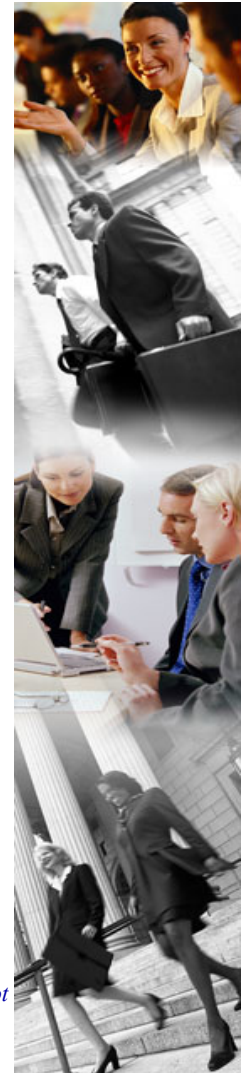
DIRECTOR DUTIES

➤ **Directors' duty of oversight was established in the 1996 Caremark decision:**

- It expanded the scope of the director's duty of care to include a duty to properly oversee company operations and established a claim for "oversight liability" based on directors' failure to establish adequate reporting systems intended to alert them to wrongful activities in the company.

➤ **At issue in Caremark was whether directors failed to properly oversee company operations sufficiently to detect employees' violations of federal anti-kickback laws that resulted in significant fines to the company. The court held that:**

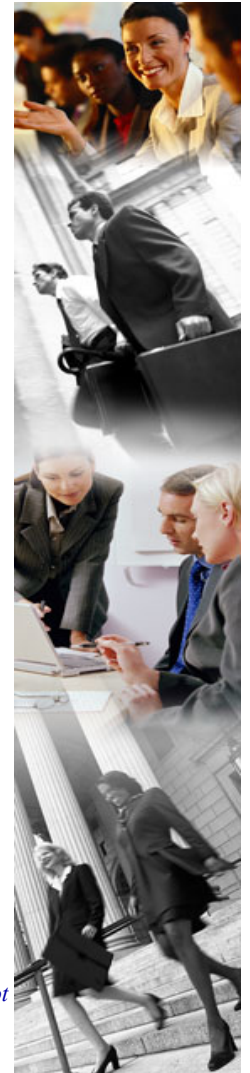
- "directors are obligated to implement and oversee an information and reporting system which is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary responsibility... and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards".
- **But "only a sustained or systematic failure of the board to exercise oversight - such as an utter failure to attempt to assure [that] a reasonable information and reporting system exists - will establish the lack of good faith that is a necessary condition to liability. Such a test... is quite high."**



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DIRECTOR DUTIES

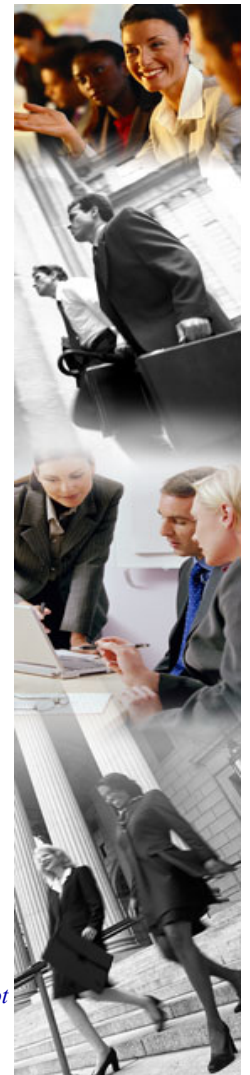
- In 2006, the duty of oversight was extended in the Walt Disney decision.
- At issue in Walt Disney:
 - Directors' approval of employment contract with Michael Ovitz containing \$130M severance provision
 - Plaintiff alleged that the Compensation Committee, and Board, failed to properly oversee both the approval of the Ovitz contract and the company's payment of severance to Ovitz when he left Walt Disney
 - Walt Disney was significant insofar as the plaintiff characterized the oversight claim as a breach of the duty of good faith -- and not just a breach of the duty of due care -- in an attempt to deprive the directors of their exculpatory provisions in the corporate charter, which protected them only if they had acted in good faith



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DIRECTOR DUTIES

- **The court's detailed analysis of the Walt Disney Board's deliberation regarding the Ovitz employment contract is a Do's and Don'ts checklist for avoiding oversight liability in the context of employment contracts:**
- To assess whether the directors engaged in meaning deliberation, the court itemized the number of Compensation Committee meetings, scrutinized the length of each meeting, and analyzed their agenda items
 - To assess whether the directors were sufficiently well informed, the court evaluated the expert financial advisors to the Compensation Committee, attached significance to whether the Compensation Committee members actually met with the advisors, or only talked with them on the phone, and analyzed the time and attention that individual directors devoted to their review of the financial spreadsheets provided to them

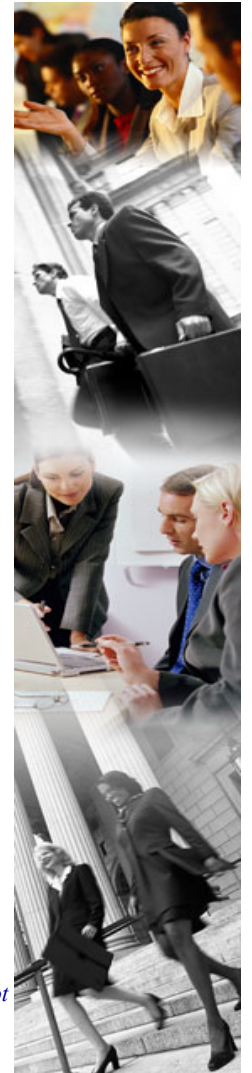


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DIRECTOR DUTIES

➤ Oversight liability claims have been alleged against directors who:

- Approved mergers
- Sold their companies, or subsidiaries
- Delayed in rectifying accounting problems
- Failed to oversee company operations
- Failed to take steps to prevent bankruptcy, insolvency
- Awarded excessive compensation to executives
- Failed to protect confidential personal data (identity theft)
[Note new FTC red flag rules regarding data security]
- Misstatement of Reporting on Options



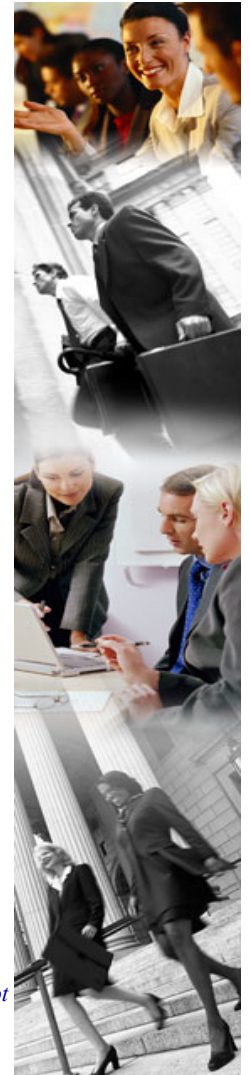
DIRECTOR DUTIES

- Prior to March 25, 2009, Delaware Court decisions were mixed as to whether directors' breach of their oversight duty is:
- only a breach of the duty of due care, in which case directors are protected by the exculpatory provisions in their corporate charter
 - also a breach of the duty of loyalty, in which case directors cannot avail themselves of their corporate charter's exculpatory provisions



DIRECTOR DUTIES

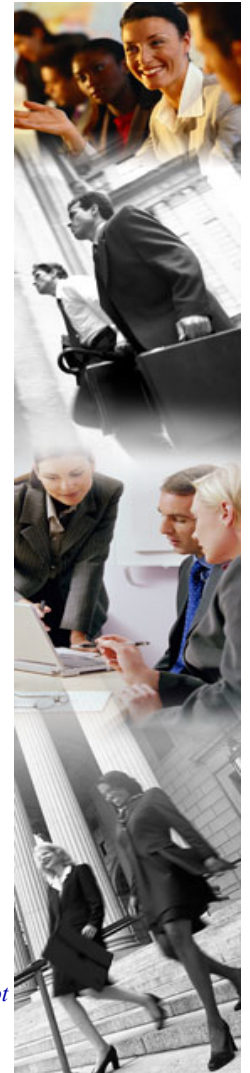
- The March 25, 2009 Delaware Supreme Court **Lyondell** decision clarifies Delaware law in favor of directors, holding that a **director’s breach of the duty of oversight -- without evidence of bad faith intent or intentional dereliction of a known duty to act --** is only a breach of the duty of due care and not a breach of the duty of loyalty.
- The Supreme Court reversed a Chancery Court decision which found a breach of the duty of loyalty based on the fact that the board delegated responsibility for a merger to the company Chair and CEO, failed to take adequate steps to investigate the adequacy of the price, and that the “whole deal was considered, negotiated, and approved by the Board in less than seven days”
 - The Supreme Court disagreed and held that the **directors’ conduct, even if “grossly negligent” was at most a breach of the duty of care, and was not bad faith because there was no bad faith or disloyal intent and the directors did not fail to satisfy a known duty to act.** Accordingly, because the corporate charter exculpated the directors from liability for all but bad faith conduct, the court dismissed the complaint against them



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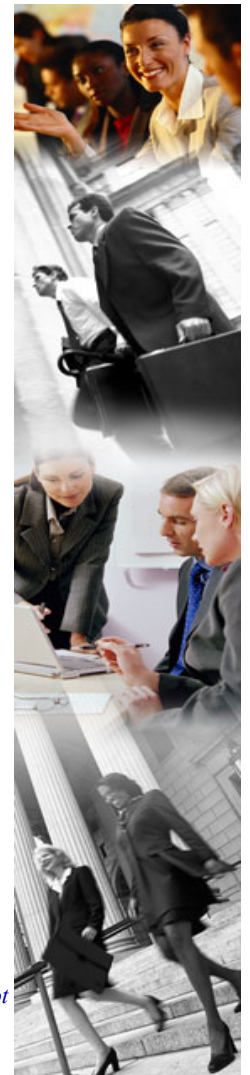
DIRECTOR DUTIES

- **Wayne County Employees Retirement System v. Corti, C.A. No. 3534 - cc (Del. Ch. July 24, 2009)**
- **First decision of Chancery Court applying Lyondell, the court stated:**
 - **It will not second guess the business decision of the board**
 - **Judicial review in the corporate sale context is limited to “the board’s decision making process”**
 - **Declined to make an independent determination of whether the consideration obtained for the shareholders was adequate**
 - **Relevant question is whether the directors “utterly failed to attempt to do all they should have done under the circumstances”**
 - **Failure to act must be in the face of a known duty to act**



DIRECTOR DUTIES

- **Conclusion: Despite the recent Lyondell and Wayne County decisions, directors must remain very aware that Board decisions will continue to be under scrutiny by the public and the company's shareholders. Extra precaution is necessary:**
- Utilize Experts
 - Understand the specific facts relating to board decisions
 - Ask "why this alternative"?
 - Have a meaningful discussion
 - Don't rush the decision
 - Make sure the minutes clearly document the informed, meaningful, good faith process by which the board makes its decision
- **WARNING:** The Congress, the SEC and the NYSE are seeking to impose new oversight responsibilities on directors that the courts have said do not exist. (e.g. Shareholders Bill of Rights Act of 2009; Shareholders Empowerment Act; Corporate and Financial Institution Compensation Fairness Act of 2009; Restoring American Financial Stability Act of 2010).



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DIRECTOR DUTIES

- The NYSE rules (as approved by the SEC) imposed risk oversight obligations on the Audit Committee (**NYSE listed Company Manual Section 303A.04**).
- The rules require that the Audit Committee “discuss guidelines and policies to govern the process by which risk assessment and management is undertaken.”
- The rules permit the company to create a separate Risk Oversight Committee or Subcommittee to perform the risk oversight function so long as the risk oversight processes conducted by the Committee are reviewed in a general manner by the Audit Committee and the Audit Committee continues to discuss the policies with respect to risk management and assessment (**NYSE listed Company Manual Section 303A.07**).
- These discussions should include major financial risk exposures and the steps the board has taken to monitor such exposure.
- They should include a general review of the company’s insurance programs to mitigate risks.



DIRECTOR DUTIES

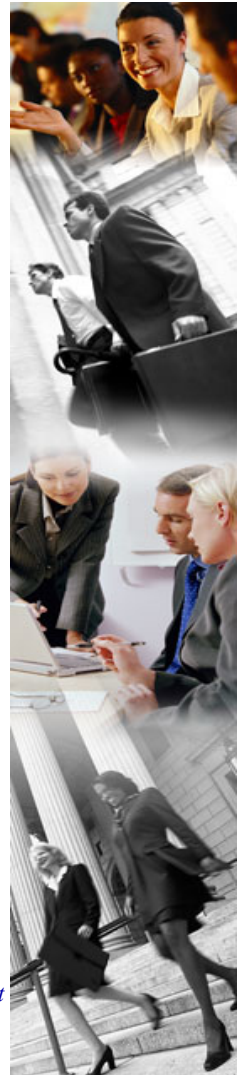
- Coordination by the board, board committee, board advisors and management is essential to effective and efficient risk management and the full board should receive reports on a periodic basis from various constituencies charged with the management of the company's risks. These risk management issues frequently arise in the context of the work of other committees and decisions of the committee should take into account the company's overall risk management system.
- For example, directors should be well-advised to review compensation awards that could be viewed as encouraging undue risks.
- Specialized committees may be tasked with specific areas of risk (i.e. financial, environmental, regulatory, litigation, etc.).
- These activities must be coordinated and communicated to the board so that a consistent level of risk, as determined by the board, can be maintained.
- A key element of the boards' risk oversight function is to discuss the various risk scenarios with the management team in order to understand how management is handling the risk management process.



DIRECTOR PROTECTION

➤ **Directors are typically also protected by exculpatory provisions in their corporate charters:**

- Delaware General Corp. Law. Sec. 145 (c): Company may indemnify its directors if they “acted in good faith and in a manner . . . reasonably believed to be in or not opposed to the best interests of the Corporation”
- Delaware General Corp. Law Sec. 102 (b) (7): Protects directors from personal liability to the company, including its shareholders, for any monetary damages caused by a breach of the duty of care



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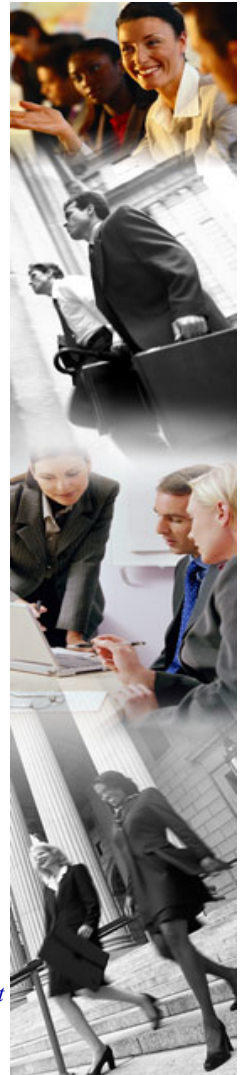
DIRECTOR PROTECTION

➤ By Laws

- Be certain that by laws require rather than permit indemnification of director and officer expenses incurred in investigations, regulatory proceedings or litigation
- By laws should require advancement of expenses

➤ Indemnity Contacts

- Protect against by law changes, hostile board, etc.



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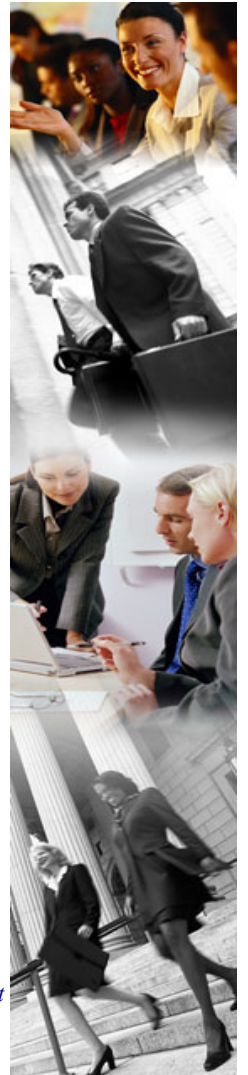
**NOTE: UNDER DELAWARE LAW AND FEDERAL LAW
THERE IS NO INDEMNITY FOR VIOLATION OF THE DUTY
OF LOYALTY OR VIOLATIONS OF FEDERAL SECURITIES
LAW. HOWEVER BOTH ARE INSURABLE RISKS.**



DIRECTORS AND OFFICERS LIABILITY INSURANCE

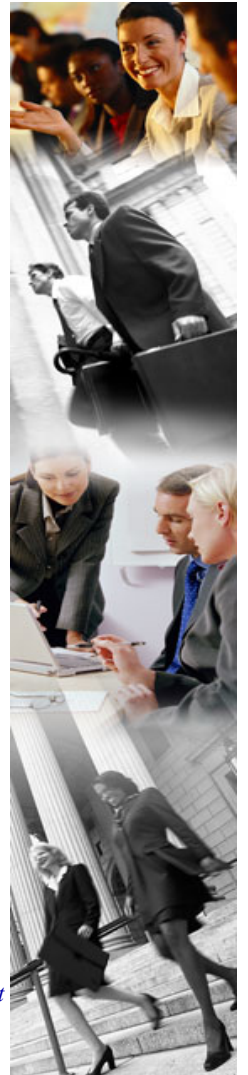
➤ Potential Gaps in Indemnification of Directors and Officers

- Claims arising out of breaches of common law duty of loyalty may be unindemnifiable .
- Public policy considerations or statutory limitations may prohibit indemnification. Examples: shareholder derivative suits and losses from violations of federal securities laws may not be indemnifiable, but may be insurable.
- State indemnification laws, the corporation's by-laws or corporate charter may be modified to limit or prohibit expected indemnification.
- A corporation may have insufficient assets to indemnify.
- A change in control of the board may create a hostile environment preventing or impairing former directors' and officers' access to corporate indemnity (but note change in Delaware statute).



DIRECTORS AND OFFICERS LIABILITY INSURANCE

- Hence, there is a need for directors and officers liability insurance protection, the purpose of which includes:
 - Filling in the gaps in corporate indemnification for D&O's (personal asset protection)
 - Providing the company coverage for defense costs and/or settlements (balance sheet/cash flow protection)

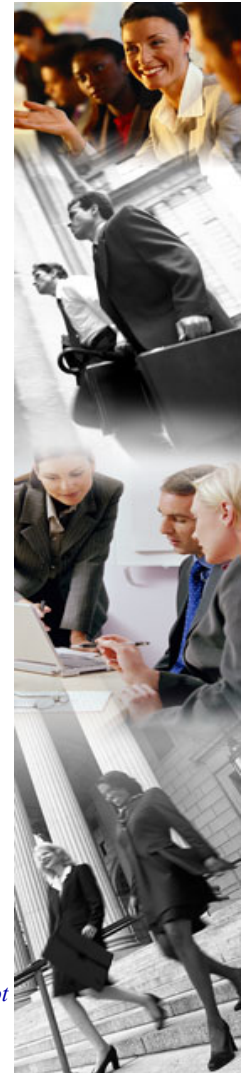


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KEY ASPECTS OF A D&O POLICY

- There are three main insuring agreements:
 - **Side A – “Non-Indemnifiable Loss”**
 - Covers Directors & Officers to the extent the company is unable or unwilling to indemnify them
 - **Side B – “Indemnifiable Loss”**
 - Covers the reimbursement of the company’s obligation to indemnify its Directors & Officers
 - **Side C – “Entity Coverage for Securities Claims”**
 - Covers securities claims against the company

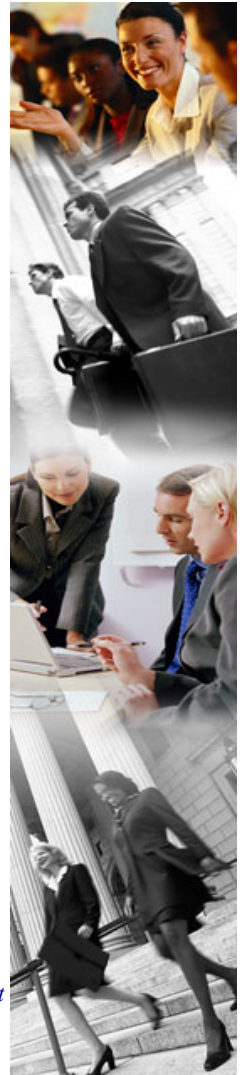
- Directors & Officers are covered for acting within their scope and capacity as Directors & Officers of their company or a subsidiary or named outside entities.



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KEY ASPECTS OF A D&O POLICY

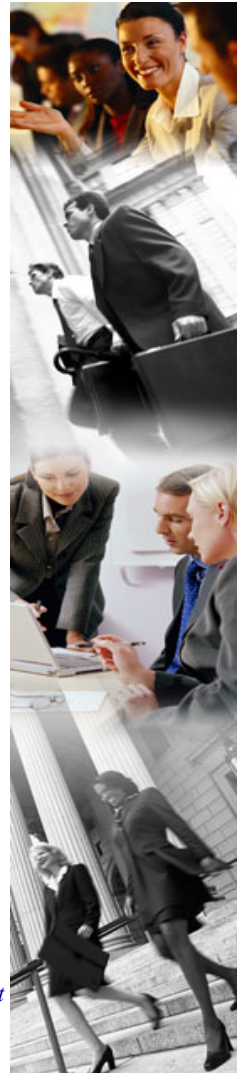
- A CLAIMS MADE policy such that a wrongful act must be reported during the policy period (or purchased discovery period) in order to gain coverage.
- One aggregate limit of liability is shared across all insuring agreements and all insureds under the D&O contract.
- The Limit of Liability includes defense costs as well as settlements and judgments.



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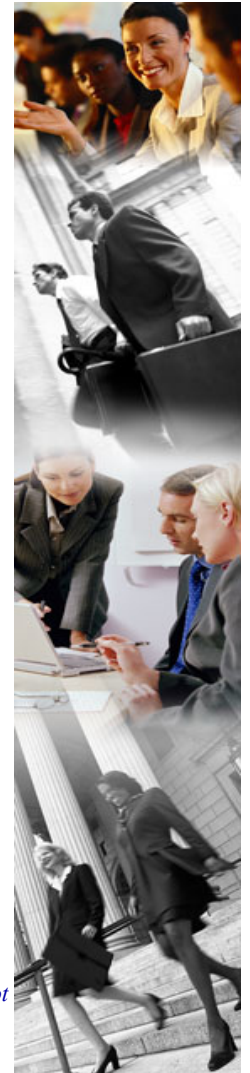
KEY ASPECTS OF A D&O POLICY

- The contract works on an “All Risk” basis (vs. Named Peril). Thus exclusions are key.
 - Unfortunately, exclusions are not only contained within the “exclusions” section of the policy, but in definitions, etc.
 - Typical/significant exclusions include:
 - Fraud, dishonesty, criminal acts (if proven)
 - Known or existing liabilities
 - Personal profit
 - Liabilities covered under other insurance contracts
 - Definition of Claims should include:
 - Investigations in response to informal inquiry by SEC or DOJ, or other regulatory or law enforcement body in the absence of a formal complaint, subpoena or target letter.
 - Internal investigations in response to notice of potential corporate wrongdoing.



KEY ASPECTS OF A D&O POLICY

- Accusation by Company against individual officer or director (i.e., Insured v. Insured coverage)
 - Derivative action by shareholder on behalf of Company
 - Coverage for Company bankruptcy (named insured owns the proceeds)
 - Priority of payments in bankruptcy (Side A paid before Sides B or C)
- Be certain that policy contains a severability clause to prevent policy from being voided because of misstatement by others.
- Policy should contain protection in the event of merger or sale
- Tail coverage (extended coverage) should be obtained for policies that are expiring.



KEY ASPECTS OF A D&O POLICY

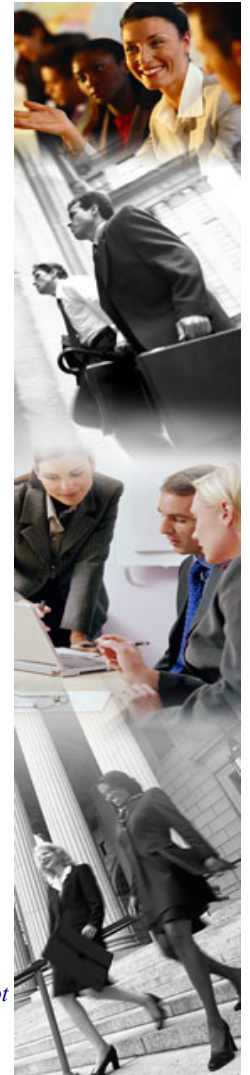
Personal Asset Protection	Balance Sheet Protection	
<p><u>Coverage Part “A”</u></p> <ul style="list-style-type: none"> • Directors & Officers liability for <u>non-indemnifiable</u> loss • No retention – Coverage from Dollar One • Direct coverage to Directors & Officers • Examples <ul style="list-style-type: none"> • Shareholder derivative action • Insolvency • Duty of Loyalty 	<p><u>Coverage Part “B”</u></p> <ul style="list-style-type: none"> • Directors & Officers liability for <u>indemnifiable</u> loss • Corporate reimbursement retention applies • Coverage for corporation’s indemnification of Directors & Officers for their liability 	<p><u>Coverage Part “C”</u></p> <ul style="list-style-type: none"> • Entity coverage • For securities claims only • Securities claims <i>or</i> entity liability retention applies • Shared with “Side B” retention
<p>SELF INSURED RETENTION</p>		



KEY ASPECTS OF A D&O POLICY

➤ Side A Drop Down Coverage

- Difference in Conditions Coverage
 - Serves as primary coverage when “Side A” does not insure
 - Includes indemnifiable claims for which company cannot or will not indemnify
 - Can be non-rescindable
 - Will give protection in company bankruptcy
 - Stand alone against waste policies (Sides A, B & C)
 - Multiple carriers (firewall)

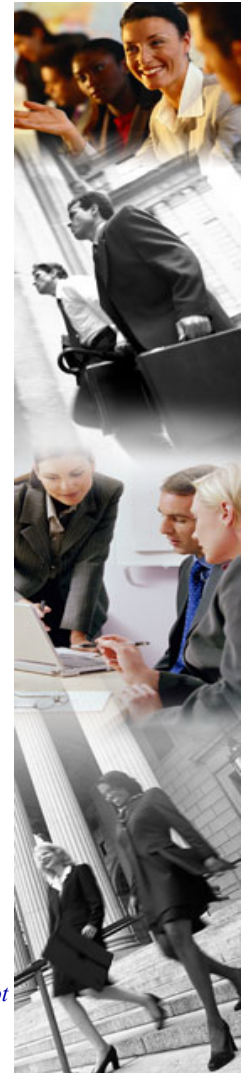


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DIRECTOR ACTION

➤ Record Retention

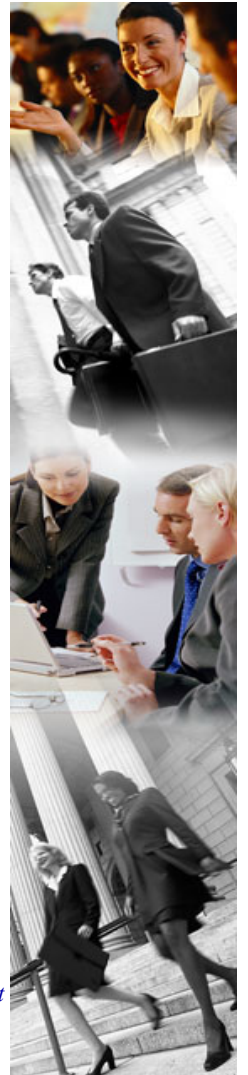
- If on notice of investigation of subject matter of your business suspend record disposal program;
- 18 USC § 1519. Destruction, alteration, or falsification of records in Federal investigations and bankruptcy.
 - Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title 11, **or in relation to or contemplation of any such matter or case, shall be** fined under this title, imprisoned not more than 20 years, or both.



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DIRECTOR ACTION

- 18 USC § 1519 – requires maintenance of records “in relation to or in contemplation of” any such investigation, matter or case;
- Different from Arthur Andersen case decided under 18 USC §1512 (c)(1) which contains “corruptly” language – unlike 1519, which only requires that the Act be “knowingly” done.
- 18 USC § 1512(c)(1)
 - (c) Whoever corruptly
 - (1) alters, destroys, mutilates, or conceals a record, document, or other object or attempts to do so, with the intent to impair the object’s integrity or availability for use in an official proceeding; or



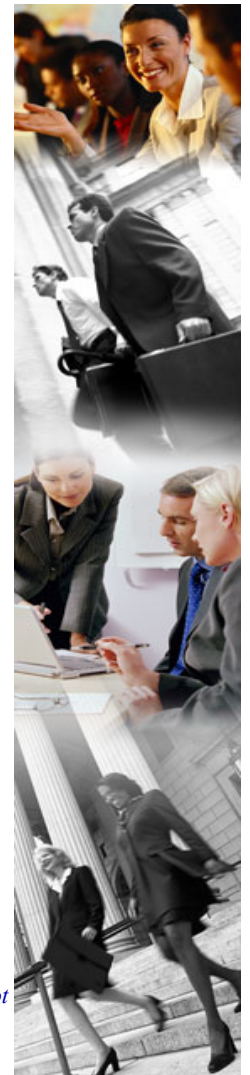
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DIRECTOR ACTION

➤ Internal Investigations

■ Initial Determination

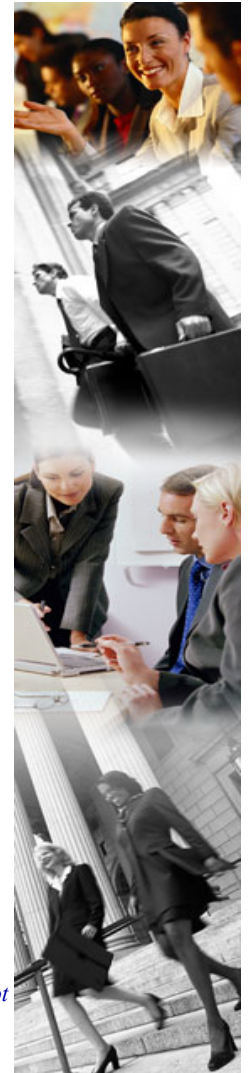
- Upon receiving a report of material violation of financial reporting or allegations or wrongdoing by management or the board the chief legal officer should make some initial determination
- What type of internal investigation should be conducted
- Who should perform the investigation
- Who is the client to whom the investigator should report
- What is the scope of the investigation
- When can the investigation be concluded
- Who makes the decision that the investigation has been completed



DIRECTOR ACTION

➤ Internal Investigations

- Factors to be Considered – Fact Specific
 - Seriousness of allegation
 - Level of detail provided
 - Whether the alleged conduct is isolated or pervasive
 - How senior are the employees alleged to be involved
 - Does the misconduct have the potential to impact materially the company's financial statements
 - Might the conduct result in criminal liability regardless of whether it is financially material to the company



DIRECTOR ACTION

➤ Internal Investigations

■ Who Should Investigate

- Consider the cost-effective and appropriate speed with which it may be completed
- Remember every quarter the CEO and CFO file their certification of financials under §302, §906, and of internal controls under §404
- In-house counsel or regular outside counsel may be in the best position to investigate quickly and efficiently because of familiarity with the company's business and personnel
- But - they may be perceived as lacking independence by regulators, law enforcement or listing bodies should the matter escalate
- General rule - the more pervasive or criminal the alleged misconduct:
 - The higher it goes in the organization
 - The more material to the company's financials
 - The more desirable it is to engage independent outside counsel to conduct the investigation



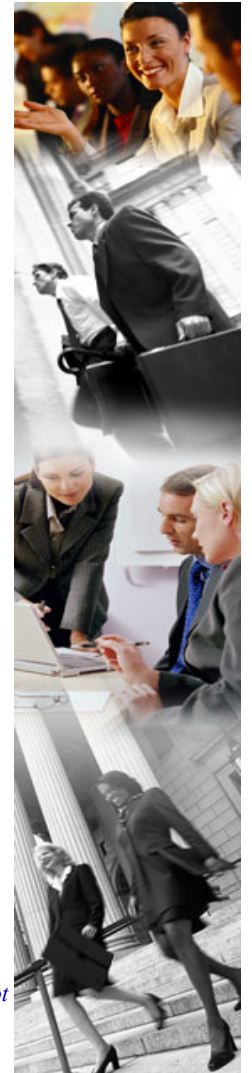
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➤ Internal Investigations

▪ Perils of Mishandling

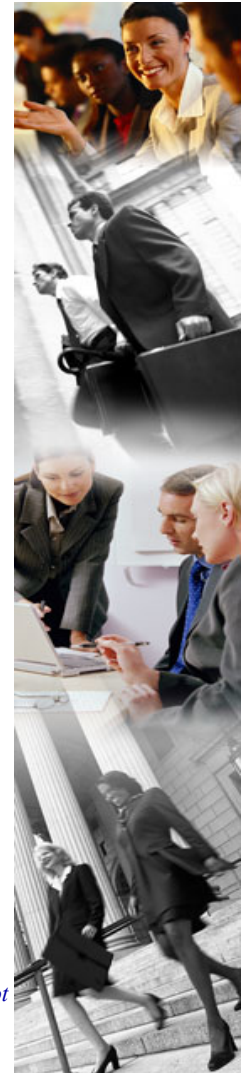
- Issue of Attorney Client Privilege and Attorney Work Product
- Interviewing witnesses requires experienced counsel
- Advice to witness re who
 - Counsel represents
 - Waiver by Company
 - Cooperation with SEC – DOJ
- Criminal implications of lying



DIRECTOR ACTION

➤ Internal Investigations

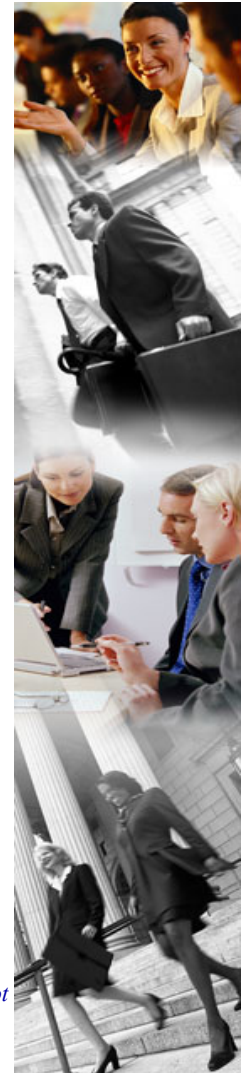
- To Whom Should Investigator Report?
 - Engagement Letter Should Specify “Client,” Scope and Reporting
 - Full board - audit committee - special committee - The CLO
 - Depends upon nature of allegations and who is alleged to be involved
 - If senior management to whom CLO reports - he should not conduct
 - Audit Committee is responsible under SOX
 - If particularly serious - appoint special committee of independent directors



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- Internal Investigations
 - When Does it End
 - Collateral Issues
 - Internal Controls
 - Appropriate Response



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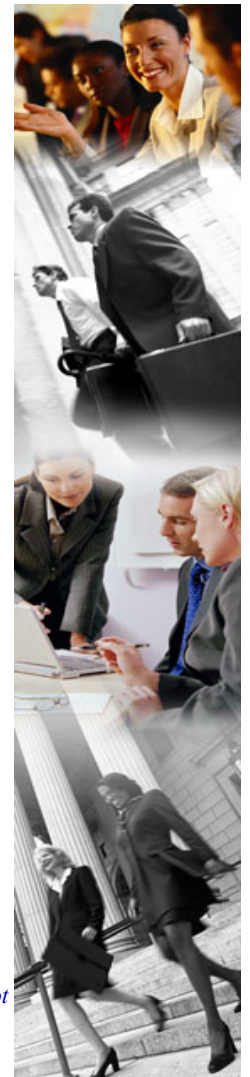
DIRECTOR ACTION

➤ Shareholder Demand

- Excused –
 - Board involved in wrongdoing
 - No independent members
- Refused –
 - Board investigates and determines claim without merit

➤ Special Litigation Committee

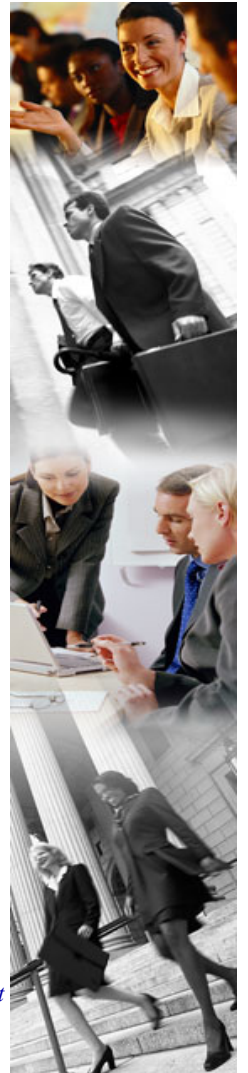
- The Standard – Zapata v. Maldonado (Del. S. Ct. 1981)
- Recent Restatement – London v. Tyrrell (Del. Ch. March 11, 2010)
- Composition – Independence
- Diligence – Interviews – Meetings
- Objectivity v. Attack Claim



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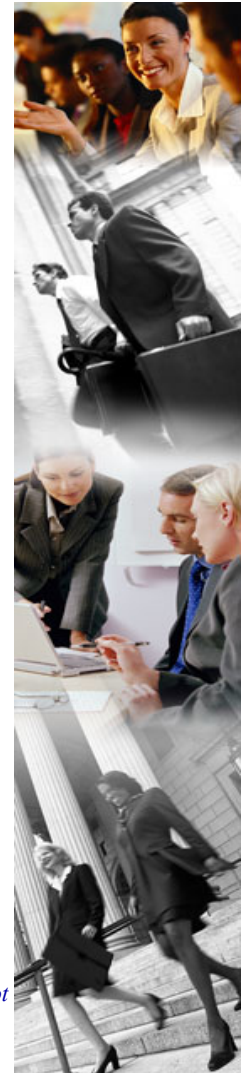
- Pre-Trial
 - Jury Surveys
 - Mock Trials
 - Preparation



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- Trial
 - Theme
 - Technology
 - Trial Graphics
 - Cost of Litigation v. Cost of Losing
 - Realistic Settlement Considerations
 - Publicity – Distraction – Diversion of Resources



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THANK YOU.

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