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The WorldCom and Enron Settlements: Imposing Personal Liability on Public Company Directors

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Multi-million-dollar personal payments made by outside directors of WorldCom and Enron have raised fears that directors are placing their personal net worth at risk by agreeing to sit on corporate boards. But the basic principles have not changed. For directors who follow these basic principles, personal liability should remain very much the exception and not the norm.

Recently, ten WorldCom outside directors agreed personally to pay $18 million of a $54 million settlement to resolve claims against them for their alleged role in WorldCom's $11 billion accounting fraud, which resulted in the largest bankruptcy in U.S. history. The $18 million the outside directors will pay out of their own pockets represents approximately 20 percent of the directors' collective net worth (excluding their primary residences, retirement accounts and certain joint marital assets), with the remaining $36 million to be paid by D&O insurance. The lead plaintiff in the case, the New York Common Retirement Fund, insisted that the outside directors pay a significant portion of the settlement from their personal assets, even though D&O insurance was available to pay the entire settlement amount.

Shortly after WorldCom's announcement, ten former directors of Enron (eight of whom were outside directors) agreed to pay $13 million of a $168 million settlement to resolve claims against them for their alleged role in fraudulent accounting practices that resulted in the second largest bankruptcy in U.S. history. The former Enron directors' portion of the settlement equals 10% of

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their personal pretax profit from their Enron stock sales.[1] D&O insurance will cover the balance of the settlement.

The WorldCom and Enron settlements are remarkable because there was sufficient D&O insurance to cover the agreed payments, and under such circumstances directors rarely have to pay from their own pockets. Outside directors may begin to worry that these settlements mean that their personal assets are now at risk. While these settlements are striking and therefore have received wide coverage in the press, their ramifications should not be overstated. **The WorldCom and Enron directors' settlements do not set new legal precedents, do not alter the scope of the business judgment rule defense for directors, and do not change the standards for directors' fiduciary duties.** The settlements are an agreement among the parties, not a judicial determination. In both cases, the outside directors rarely challenged top executives or performed an in-depth evaluation of the major corporate transactions they approved.

The WorldCom and Enron directors' settlements serve as an important reminder that outside directors should be diligent, follow the proper processes, avoid conflicts of interest, and act on a fully informed basis when taking any board actions. In addition, and as the Delaware Chancery Court has held, directors have a responsibility to assure that an adequate monitoring system exists for receiving corporate information and reporting, and directors may be held personally liable if there is a sustained or systematic failure to exercise oversight.[2] Other suggestions for directors include:

- Be diligent, ask questions, request information and attend meetings. Evaluate the system of reporting information up the chain of command. Work with management quickly and efficiently to address material compliance issues, internal control deficiencies, and other red flags.
- Devote the time necessary to fulfill director duties and understand the nature of the corporation's business. Limit the number of boards on which you sit if necessary.
- Avoid engaging in, or fully disclose, any related transactions or conflicts of

[1] The Enron outside directors' agreement to pay back a portion of their personal trading profits on Enron stock is notable because a federal judge in Houston in 2003 dismissed the insider trading and fraud claims against the former directors. *See In re Enron Corp. Securities, Deriv. & ERISA Litig.*, 258 F. Supp. 2d 576, 623-38 (S.D. Tex. 2003). The court held that the plaintiffs had not pleaded facts sufficient to establish fraudulent intent or that the outside directors had personally benefited from any non-public information in trading their Enron stock. However, the court refused to dismiss most of the claims under section 11 of the Securities Act of 1933. These were claims for making materially misleading statements in registration statements or prospectuses. The court held that defendants' due-diligence defense to these claims could not be determined in a motion to dismiss. *Id*. at 639. Section 11 claims (unlike after-market claims under Rule 10b-5) only require proof of negligence by the directors (and a lack of adequate due diligence), not proof of actual knowledge of the falsehoods or deliberate recklessness. Had they engaged in more thorough diligence on the disclosures in the registration statements and prospectuses, the Enron directors probably would not have been subject to the same pressures to settle that led them to contribute their own funds.

[2] *See In re Caremark International, Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

interest. This is necessary to assure the benefits of the business judgment rule defense. Where a conflict of interest does exist, a trial court may apply a more exacting standard of review, and may shift the burden of proof onto the defendant to prove that the transaction in question was fair to the corporation.

- Review public offering registration statements, prospectuses and other public filings carefully. Counsel should be directed to review with the board any issues, to give the directors an opportunity to ask questions and request information. Establishing clear board processes is essential to an assertion of the due diligence defense for claims under section 11 of the Securities Act of 1933, which imposes liability for materially false or misleading statements in a registration statement but allows a due diligence defense. The due diligence defense requires proof of the reasonableness of the directors' investigation, and the investigation may include reliance on an expert's opinion.
- Avoid significant deviations in established patterns of selling or buying the corporation's stock, or sell pursuant to a 10b5-1 plan. Unusual trading patterns in large volumes of stock may be used as a factor to establish scienter (knowledge of the wrongdoing or deliberate recklessness) in shareholder claims alleging fraud.
- Give appropriate time and attention to board matters regarding executive compensation and related party transactions. In the recent Disney shareholder lawsuit regarding Michael Ovitz' executive compensation, shareholders claimed the directors "failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders"[3] when directors approved a compensation package presented by Michael Eisner, Disney's CEO and a close friend of Ovitz. The package included termination provisions worth $140 million, which were triggered and paid out when Ovitz was fired less than a year later. These compensation matters can serve as lightening rods for public opinion and intense media scrutiny and do not present well before a jury, regardless of the rationale at the time of the decision. Other recent examples are the $408 million loan the WorldCom board approved for CEO Bernard Ebbers to cover his personal margin calls on WorldCom stock and the substantial personal benefits received by Andrew Fastow, Enron's CFO, and other executives from the off-balance sheet entities approved by the Enron board. These types of issues may make it difficult for directors to win a case on a pretrial motion and may color the jury's view of the facts should the case proceed to trial. Issues such as these therefore should be handled with care.
- Conduct appropriate due diligence on a corporation before accepting a board seat. Review the corporation's compliance with NYSE or Nasdaq

[3] *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003). *See also Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)(reversing the lower court's dismissal of the action and allowing the Disney shareholder plaintiffs to file an amended complaint regarding the directors' alleged breaches of fiduciary duty and waste for approving Michael Ovitz' compensation package).

corporate governance rules, as well as its compliance with the Sarbanes-Oxley Act of 2002.

- Enter into full indemnification agreements and ensure there is adequate D&O protection, including coverage for directors and officers only. Such coverage provides additional protection if the corporation is unable to make its indemnification payments or there is a corporate bankruptcy.

Today, as in the past, outside directors may protect themselves by following proper board processes and practicing good corporate governance. That means assuring that the corporation has in place systems designed to drive relevant information up to the board level. That also means being diligent, asking questions, seeking expert guidance as appropriate and acting only when you have before you enough information on the subject at hand to allow you, as a fiduciary, to make a prudent and reasonable decision.

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