Director Liability: WorldCom And Enron Directors' Recently Proposed Settlements – The New Reality Of Personal Liability For Directors

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Historically, outside directors enjoyed a safe harbor created by the interplay of the state corporate law business judgment rule defense as well as the two "I's": indemnification (by the corporation) and (directors' and officers' liability) insurance. However, the recent Delaware law decisions in *Abbott, Disney and Emerging Communications* effectively have substituted a negligence standard for the "good faith" component of the business judgment defense. This jeopardizes the ability of directors to achieve indemnification and insurance coverage. The practical effect has been to increase the incentive for directors to settle suits that survive motions to dismiss. Now, however, the Enron and WorldCom scenarios raise the prospect that directors may not be able to settle without contributing from personal assets.

Some practitioners caution against overreacting, saying that the proposed Enron and WorldCom settlements are in the context of high profile financial frauds, with public fund plaintiffs demanding personal funds from directors who clearly were not providing oversight. We can be assured that events which cause a company's stock to drop 10 percent will lead to plaintiff lawyer suits alleging the directors were "asleep at the switch" regardless of the true cause of the stock drop. The new protocol of demanding that directors pay personally will not distinguish those situations from "high profile financial frauds." In other words, when significant stock drops occur, directors are now prime targets, and the pot just got bigger from the perspective of the plaintiffs' bar.

What Is The Message To Directors?

- If a director is found to have breached a fiduciary duty because of lack of good faith, the corporation cannot, under the laws of most states, indemnify the director and D&O insurance may not pay for the damages (depending on the insurer's, usually quite broad, ability to interpret coverage provisions) – potentially leaving a director with personal liability for the entire amount of damages awarded by the court.
- Even when D&O insurance does cover director acts where a court finds a "lack of good faith," it is likely that directors will have to go through more litigation hassles under a weakened business judgment rule. The time and effort for directors to stay in a case that survives a motion to dismiss or the risk that, even in settlement, they may be paying with personal funds, clearly create greater risks to being a director.
- Individually, directors need to be serious about their duties under *Caremark,* demanding that compliance systems be in place and that governance best practices be followed.
- Collectively, the corporate world should educate its "stakeholder" world, including institutional shareholders, regulators, legislators and other outside interest groups, that unintended consequences of driving needed talent from board rooms are occurring. These same stakeholders need to be educated that punishing directors should be reserved for situations of much greater culpability than lapses sounding in negligence. The "good faith" test in the business judgment rule should be returned to a requirement tantamount to intentional misconduct.

Background: Why The Climate Is Different Now

Under state law, to incur personal liability, a plaintiff must show that a director breached his duty of loyalty or duty of care to the corporation or its shareholders. Delaware has long limited director liability for the breach of duty of care though the *business judgment rule*, under which a director who is reasonably informed and acts in good faith is irrefutably presumed to have satisfied the duty of care. In addition, Delaware law allows corporations to adopt charter provisions that limit the liability of directors for breach of duty of care, with one of the exceptions to such limitation being "… for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law."

Traditionally, acting in "good faith" meant not having a personal financial interest in a transaction that the director was approving and being "reasonably" informed and deliberating prior to making a decision (which meant, effectively, that a director was shielded by the business judgment rule so long as the director was not wantonly derelict in his duties). However, in two recent decisions, not related to the Enron and WorldCom settlements noted above, courts effectively have applied what amounts to a negligence standard to determine if a director acted in good faith, thus extending the boundaries of director liability beyond the scope recognized by courts in years past.

In a landmark 2003 Delaware case involving Walt Disney Co.'s $140 million-plus severance agreement with Michael Ovitz, the Delaware Chancery Court found that Disney's §102(b)(7) charter provision would not protect Disney's directors if the plaintiffs could show bad faith by proving the directors' intentional failure to review Ovitz's entire compensation package. Accordingly, if the plaintiff prevails on the merits, the Disney directors may be without corporate indemnification. So far we have a case that has survived a motion to dismiss. It appears that the testimony has been strong for the defendants in the pending trial, and that the directors (and their D&O insurer) may ride it out until a final verdict is rendered. Unlike Enron and WorldCom, where the directors' liabilities might have been outside their D&O policy limits, the risk in *Disney* that the directors would have exposure outside the policy limits appears remote.

In a 2001 Illinois case, the U.S. Court of Appeals for the Seventh Circuit similarly held that the directors could be held personally liable for damages incurred by the company despite exculpatory provisions in the corporation's charter. The court noted that the directors of Abbott Laboratories had received repeated warnings over a six-year period that some of Abbott's processes were allegedly in violation of FDA regulations. Accordingly, the court denied a motion to dismiss the claims, because the directors' alleged disregard of the known violations would amount to bad faith.

In the WorldCom and Enron cases, the directors had substantial incentive to settle (the 340-page special committee report in WorldCom listed numerous instances of inaction and lack of investigation on the part of the board, which findings could have supported a lack of "good faith" claim) and the institutional plaintiffs used this in formulating the settlement terms – the directors would either pay part of the settlement out of their own pockets now, or they could take their chances in court, where potential damages (which, if the plaintiff's proved lack of good faith, the directors might have had to pay part of out of their own funds anyway) could have exceeded D&O insurance policy limits. With the gray cloud of the courts' decisions in *Abbott* and *Disney* – that their respective directors' actions (and inactions) in approving corporate matters amounted to bad faith and could cost such directors personally – already looming, it is not a surprise that the WorldCom and Enron directors agreed to settle in this manner. In light of the WorldCom court's rejection of the directors' proposed settlement, it appears that their personal risk has been increased absent a global settlement shielding them from exposure to a potential jury verdict against them personally.

Many practitioners are dismissing these two settlements as "rare occurrences" with just the right blend of facts: highly publicized cases, insolvent corporations, extreme fraud by executives, billions in lost shareholder dollars and numerous outside directors with deep pockets. However, it is the shift from a "good faith" test to a "negligence" test in *Disney* and *Abbott* and the precedent of personal payments by directors that sets the new paradigm in litigation against directors, not the peculiar facts of WorldCom or Enron, and that should be of concern to practitioners and directors alike.

The recent unpublished decision by the Delaware Chancery Court to hold a director liable for breach of fiduciary duty, for voting for a transaction that he knew (or should have known) was unfair to minority shareholders, is one more example of the personal exposure of directors. In this case, involving Emerging Communications, Inc., a U.S. Virgin Islands telephone company, the director, Muoio, was a partner in an investment advisory firm and a former securities analyst with extensive telecom experience. The court held that Muoio was not entitled to rely on a fairness opinion on the share price, as his "special expertise" should have led him to the conclusion that the share price was unfair. This case raises a serious question about the liability of experts on boards of directors and board committees. Under the Sarbanes-Oxley Act of 2002, corporations now have to disclose whether they have a financial expert on their audit committee. Although the SEC has stated in the past that audit committee financial experts have no greater liability than other directors, the ECM case shows that the courts may not agree with the SEC.

The rhetoric from regulators has added credibility to the notion of holding directors who were on the watch when "bad things" are deemed to have occurred personally liable. In his speech to the UCLA School of Law in September 2004, SEC Division of Enforcement Director, Steve Cutler stated that one of the [SEC] enforcement programs would help prevent a recurrence of the corporate abuses that led to the adoption of Sarbanes-Oxley by, "… holding gatekeepers responsible, aggressively pursuing obstruction of our investigations, and creating more personal accountability and deterrence in the corner offices of America's public companies."

The problem with the new rhetoric is its failure to honor the need for an overall system of governance that will attract and keep highly qualified directors. Existing law has mechanisms for punishing the wrongdoer directors. The recent ad hoc actions of the courts reinterpreting "good faith" will become the system, as will plaintiffs seeking the personal wealth of directors. The result will be an unnecessary exodus of talented people from the board room. This is a policy issue that corporate America should take head on.

Steps To Be Taken

From a policy perspective, the business judgment rule's historic protections need to be restored. Meanwhile, there is great need to educate today's directors so they can understand their risks and take all steps to protect themselves. Beyond ensuring proper indemnification provisions in charters and bylaws and updating D&O policies, corporations should take *Caremark* and the Federal Sentencing Guidelines seriously, with emphasis on the following:

- Emphasize to their board that they must be proactive. Encourage directors to be vocal when they see actions that may harm the corporation (warning them that if they fail to act, or act without sufficient information, they may be deemed to have failed to act in good faith).
- Provide directors all information and material relevant to a decision as far in advance of meetings as possible. Encourage questions from directors about the material provided and document such questions and the corporation's responses.
- Explain that board discussions must be extremely detailed and the meeting minutes should carefully document the process of full discussions.
- Explain that the board should review final (or close to final) versions of transaction documents. If the version presented at the board meeting is not in substantial final form, the board should meet again on the same agreement and establish limits on revisions that can be made without returning to the board for further approval.
- Encourage the board to seek the advice of outside experts where appropriate, and make sure experts are independent of the corporation.
- When appropriate, present the board with alternatives to proposed transactions that the corporation has considered for discussion and document the board's discussion and consideration of the consequences of acting and not acting on proposed transactions.
- Explain that the board should have several (not just four) face-to-face meetings a year, and at each meeting independent director executive sessions.

An expanding practice for many of us is independent compliance reviews to give comfort to boards of directors that sound compliance systems are in place and that discovered gaps have been closed. Today, most corporations still have fragmented compliance systems without the needed integration to satisfy the *Caremark* requirements and such an independent review is advisable.

Need To Reform The Reforms

The business community is rightfully beginning to speak out about needed adjustments to the unintended consequences of legislative, regulatory, and judicial responses to the unfortunate scandals of this decade. Many good reforms have been enacted, but fine tuning is needed. First and foremost, the scales must be adjusted to allow good directors to serve without unwarranted great risk to their personal finances.

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