DIRECTOR LIABILITY IN THE WAKE OF THE WORLDCOM AND ENRON SETTLEMENTS

Two recent cases may signal a trend by institutional investors in demanding that outside directors forego the benefits of D&O insurance and use personal funds to settle shareholder lawsuits.

On January 6, 2005, it was reported that ten former outside directors of WorldCom Inc. had agreed to a $54 million settlement for their roles in WorldCom’s $11 billion accounting fraud, which resulted in the largest bankruptcy in U.S. history. One-third, or $18 million, of the settlement would have been paid by the directors personally, with the balance paid by WorldCom’s D&O insurance policy. The $18 million represented approximately 20% of the directors’ cumulative net worth, excluding primary residences, retirement accounts and judgment-proof joint assets. WorldCom’s bankruptcy followed the discovery of approximately $9 billion in accounting errors and led to the indictment of its former CEO Bernie Ebbers. WorldCom eventually restated its pretax income for 2000 and 2001 by $74.4 billion. It was also revealed that the board of directors approved $400 million in loans and guarantees to Mr. Ebbers.

Soon after the announcement of the WorldCom director settlement, it was reported that in a confidential agreement reached last October, ten former directors of Enron Corp. agreed to personally pay $13 million of a $168 million settlement to resolve claims against them for their alleged role in Enron’s fraudulent accounting practices that resulted in the second largest bankruptcy in U.S. history. The Enron directors’ portion of the settlement represents 10% of their personal pretax profit from their Enron stock sales. D&O insurance will cover the rest of the settlement. Enron’s bankruptcy stemmed from accounting practices that permitted Enron to hide billions of dollars in debt in off-balance sheet partnerships. More than 30 individuals have been convicted or pleaded guilty for their roles in the failure of Enron, and former CEOs Ken Lay and Jeff Skilling have been indicted and are awaiting trial.

The WorldCom and Enron cases are unique in many ways and do not so far involve a judicial determination of liability or the setting of new standards governing director duties. These cases, however, represent a significant development and will likely serve as precedent for the use of personal funds to settle lawsuits against outside directors. Alan Hevesi, New York State comptroller and trustee of its Common Retirement Fund (the lead plaintiff in the WorldCom case), has been quoted as saying, “I felt personally that this would be unfair and not a deterrent for future failures on the part of directors if they weren’t held personally liable. The notion that companies can commit fraud and that the directors can ignore that and not meet their obligations as fiduciaries and be covered by insurance is just wrong.”

Practical Advice to Minimize Personal Liability

Directors can minimize personal liability by acting diligently and on a fully informed basis, including:

• following proper board processes;
• ensuring that an adequate system exists for receiving corporate information;
• remedying all regulatory and accounting deficiencies quickly and thoroughly;
• practicing good corporate governance, including increased vigilance over compliance with the Sarbines-Oxley Act of 2002 as well as NYSE or Nasdaq corporate governance rules; and
• paying special attention to executive compensation issues and related-party transactions.

Directors should also make certain that they have entered into adequate indemnification agreements with the corporation and ensure that there is sufficient D&O insurance coverage, including separate “Side-A” insurance that protects outside directors when the primary D&O insurance coverage has been depleted or when a corporation is unable to meet its contractual indemnification obligations.

In addition, director candidates should engage in enhanced diligence prior to accepting a board seat and only associate with corporations and management teams that maintain the highest ethical standards.
On February 2, 2005, it was reported that the settlement fell apart after a judge ruled that one aspect of the deal limiting the directors’ potential liability was illegal because it would have exposed co-defendant investment banks to greater damages. As a result, the ten directors will remain defendants in the case and face the possibility of paying significantly more than they had agreed to in the settlement if they are found liable by a jury for investor losses. The case is scheduled to go to trial on February 28, 2005.

For further information regarding director liability issues, please contact any of the attorneys listed below or any other member of our Public Companies Group at (415) 434-1600.

- Lawrence B. Rabkin
- Richard W. Canady
- Michael J. Sullivan
- Deborah A. Marshall
- Joseph Hershenson
- Larry W. Smith
- J. Alex Moore
- Maurine M. Murtagh
- Erin C. Furman

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