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Stormy Weather

The Enron and WorldCom Settlements Make Waves

IN TWO LANDMARK AGREEMENTS THAT sent shockwaves through corporate boardrooms this winter, former outside directors of WorldCom, Inc., and Enron Corp. each tenatively agreed to personally pay millions of dollars to shareholders to settle cases arising out of the massive frauds at each company. Historically, such settlements had been funded almost entirely by companies and/or insurance companies, with individual directors—especially outside directors—never paying out of their own pocket.

Although the WorldCom settlement was rejected by the federal district court overseeing the litigation, both it and the Enron settlement are causing directors to re-evaluate the risks of public board membership and methods to minimize these risks. In particular, directors are asking themselves—and their advisors—what actions they can or must take to meet their fundamental duties of care, good faith, and loyalty to the company and its shareholders. Similarly, directors want to know what concrete actions they can take to reduce their personal exposure, and whether the risk profile of being a director has changed so dramatically that the normal benefits of the job are no longer adequate.

These are not easy questions to answer, but there are several points to keep in mind about the WorldCom and Enron situations. WorldCom had the largest accounting restatement in history. The company eventually admitted that its pretax income for 2000–01 was overstated by $74 billion, and that it had failed to deduct basic expenses of more than $4 billion. While this fraud was occurring, the company's board awarded huge compensation packages to WorldCom's chief executive officer, Bernard Ebbers, including more than $400 million in loans. Many of the parties involved in WorldCom face unprecedented civil and/or criminal liability. Citigroup Inc., one of WorldCom's bankers, agreed to pay $2.65 billion to settle claims against it, while at press time Ebbers was being tried on criminal charges for securities fraud and conspiracy. (He pleaded not guilty.)

The facts in the Enron case were similarly egregious. As at WorldCom, Enron's fraud resulted in the company being forced into bankruptcy, with shareholders losing hundreds of millions, if not billions, of dollars. More than three dozen people, including virtually all of the company's former senior officers—such as its chairman, CEO, chief financial officer, and chief accounting officer—have been charged with various crimes relating to their activities at Enron. Andrew Fastow, the company's former CFO, has already pled guilty to fraud and conspiracy charges and been sentenced to ten years in prison.

In short, there are enough unique facts about WorldCom and Enron to consider them the "storms of the century" with respect to corporate fraud. Further, these cases combined the two situations creating the greatest risk for directors: (a) a huge accounting restatement and (b) bankruptcy. Whenever the stars align to bring these together, the risks for directors increase dramatically. Because the company is in bankruptcy, its agreement to indemnify its directors is meaningless because the company does not have the money to back its obligation. In addition, the restatement means that the company's earlier financial statements were inaccurate, making it difficult to win any litigation on the merits.

Enron and WorldCom aside, there is no question that the risk profile for directors of public companies has changed.

At a Glance

- Several former Enron and WorldCom directors have agreed to pay out of their own pocket to settle shareholder suits.
- Board members shouldn't panic. Few corporate frauds are as egregious as those at WorldCom and Enron.
- Still, directors are likely to face more attempts to hold them personally accountable.

In this new world, a number of corporate constituencies, regulators, and others are demanding individual accountability from directors when things go wrong at the corporation. For example, the lead plaintiff in the WorldCom case, the New York State Common Retirement Fund, apparently made it a condition of the settlement that the outside directors contribute a significant amount of personal assets to the settlement, regardless of the amount of insurance available.

The WorldCom settlement was recently rejected by the federal district court overseeing the litigation. The court held that a key provision of the proposed settlement agreement limiting the potential liability of the settling defendants violated the Private Securities Litigation Reform Act. Yet notwithstanding this rejection, institutional investors, plaintiffs attorneys, and others have announced in recent months that they intend to continue pressing for individual directors to use their own funds to settle cases, just as it has become more typical for plaintiffs to seek corporate governance changes in securities litigation settlements.

Other groups are also making efforts to hold directors accountable. The SEC has adopted a policy that can prohibit a defendant who pays money to settle an action from seeking reimbursement from either the company or any D&O policy. Further, the SEC's director of enforcement has announced the SEC's intention to "[focus] closely in our investigations on whether outside directors have lived up to their roles as guardians of the shareholders they serve." Even the Delaware courts have recently appeared to hold directors to a higher standard of care and good faith, especially when a director has "special experience" in a particular area of consideration by the board.

> It is likely that institutional investors and plaintiffs attorneys will press for individual directors to use their own funds to settle more shareholder suits.

Directors should clearly understand the financial and reputational risks of serving on a board. Under the proposed WorldCom settlement rejected by the district court, the directors agreed to pay 20 percent of their aggregate net worth, minus their homes and retirement accounts. In contrast, the fees paid to WorldCom directors peaked at $35,000 per year, plus $1,000 per meeting. The Enron settlement required directors to pay 10 percent of their net trading profits on Enron stock (and thus was at least linked to the amounts they made from Enron). The hit to the reputations of these former directors was just as great.

Directors are naturally wondering which additional steps they can take to minimize their risk of exposure. There are three points to remember:

First, directors are never going to have a Batman-like utility belt from which they can pull out a shield or other gadget to protect them from danger. Instead, most of the "protection" available to directors comes from diligently doing the basic work of board membership. This includes preparing carefully for meetings; attending meetings; focusing on hot-button issues, such as anything involving self-dealing, accounting issues, corporate transactions, or executive compensation; and making sure that the company's top executives set a tone communicating that nonethical behavior will not be accepted. There is nothing especially novel about this advice, but it is worth remembering.

Second, directors should remember that if they are forced to justify their behavior in a subsequent lawsuit, their actions will be judged in hindsight and for proper process. Plaintiffs lawyers, courts, and/or juries will want to know why the director made a particular decision, and what information that decision was based on. It is important to ensure that there is an adequate documentary record to support both the board's deliberative process and the reasons for its decision. This does not mean a paper mountain, but it does mean that directors should make sure that their advisors maintain appropriate records.

In litigation, often the most important questions are the simplest ones. For example, in the Enron case, the question that keeps coming back is why the directors were not aware of the special purpose entities through which the company improperly inflated its financial results. As a general matter, a director is much more likely to be criticized for what later appears to be an obvious, even simple issue, rather than for a complicated business judgment.

Finally, it is time for directors to take a renewed interest in the topic of insurance. Directors should insist on having the company's indemnification agreements and D&O policy reviewed by counsel on a regular basis, so they understand the parameters of these agreements. Board members should at least consider having the company purchase "Side-A" coverage, which stays with the directors even if the company is bankrupt. Similarly, directors may wish to consider purchasing their own personal umbrella policies (PUPs), which are personal to the individual and can be used if for some reason the company's policy is unavailable.

The Enron and WorldCom settlements have created new risks for directors. However, with some care, these risks can be properly managed, and even in today's environment, serving on a public company board is usually a rewarding and interesting experience. ■

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