IN TWO LANDMARK AGREEMENTS THAT sent shockwaves through corporate boardrooms this winter, former outside directors of WorldCom, Inc., and Enron Corp. each tentatively 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.
It is likely that institutional investors and plaintiffs
attorneys will press for individual directors to use
their own funds to settle more shareholder suits.
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.
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.

D irectors 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.