Legal Backgrounder

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2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

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ENRON AND WORLDCOM SETTLEMENTS REFLECT NEED TO REEXAMINE DIRECTOR LIABILITY STANDARDS

by

David E. Brown, Jr. and Michael P. Reed

Recently, certain directors of Enron and Worldcom agreed with investor plaintiffs to settle securities class action lawsuits filed against them and a host of other defendants. Many commentators decried the settlements for their potentially adverse effect on the ability of other public companies to attract and retain qualified directors, a process already made more difficult by the enactment of the Sarbanes Oxley Act of 2002 (SOX) and related rulemakings by the Securities and Exchange Commission (SEC), the adoption of new corporate governance listing standards of the New York Stock Exchange (NYSE) and Nasdaq Stock Market (Nasdaq), and some recent Delaware court decisions raising the specter of expanded director liability for breaches of fiduciary duty.

While these settlements raise serious issues that directors and their advisors should consider, the settlements raise few if any new or novel legal issues (despite recent commentary to the contrary). Many public companies have filed for bankruptcy and their directors and officers have been sued for a smorgasbord of violations, including breaches of fiduciary duties and violations of federal securities laws. In some of those cases, directors and officers have used personal funds to settle the lawsuits for a variety of reasons.

It is fair to question, therefore, whether these settlements, and the other developments noted above, are likely to have a meaningful adverse effect on the willingness of otherwise qualified individuals to serve as directors of public companies. Are there important public policy goals that would be undermined by such a result? Should existing securities laws and state director liability schemes be re-examined and, if so, what might be the appropriate contours of any revised structures?

The Enron and Worldcom Settlements. In the proposed Worldcom settlement, ten former outside directors agreed to contribute $18 million to a $54 million settlement of certain securities law claims. As a result of the effect of complex provisions of the Private Securities Litigation Reform Act of 1995 on the computation of the damages that might be owed by non-settling defendants, the plaintiffs terminated the director portion of the Worldcom settlement, leaving those former Worldcom directors

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David E. Brown, Jr. and **Michael P. Reed** are partners in the Washington, DC office of the law firm Alston & Bird LLP.

still party to the securities litigation.[1] In the Enron settlement, 18 former Enron directors settled certain securities law claims, with 10 former directors agreeing to contribute $13 million to the $168 million settlement.[2]

Both lawsuits involve claims under Section 11 of the federal Securities Act of 1933 ("Securities Act"), which imposes on the defendants, including the company, its directors, certain officers, its accountants, and its underwriters, strict liability for material misstatements in and omissions from, the registration statements used to offer securities. The only defense available to the directors (and the defendants other than the company) is what is colloquially known as the "due diligence" defense, which requires that the defendant demonstrate that he or she conducted a thorough review of the information contained in, or omitted from, the registration statements used to sell securities to investors and could not have known about any material misstatements or material omissions in the registration statements. The due diligence defense provides, in theory, an avenue for directors to demonstrate that they discharged the particular oversight role assigned to them under the Securities Act.

The Enron and Worldcom lawsuits involve hundreds of billions of dollars in lost shareholder value for which each director faced personal liability with limited, and dwindling, insurance available to cover the litigation costs and potential damage awards against them. As a result, the former directors were under tremendous pressure to settle the claims against them and limit their personal exposure to potential damage awards. Settling these types of lawsuits is nearly universal, particularly given that the potential damage awards typically exceed the limits of directors and officers insurance that is available. However, they are usually settled within the scope of, and with the use of, directors' and officers' insurance proceeds and corporate funds. While personal contributions in securities fraud cases involving bankrupt corporations are not particularly new, the potential size of the damage awards makes the Enron and Worldcom settlements at the very least "eye-catching," and thus subject to continued press coverage.

Delaware Developments. In addition to their exposure under the securities laws, directors face potential liabilities under state law for breaches of fiduciary duty. Traditionally, corporate fiduciary duties were described as having two components, a duty of care and a duty of loyalty, although more recently, some state courts (particularly in Delaware) have characterized fiduciary duties in terms of a "triad" consisting of the duties of care, loyalty, and good faith.

Whether or not notions of good faith can be subsumed in the duty of loyalty is, to some extent, academic, as both affirmative disloyalty and a failure to discharge one's fiduciary duty in good faith can nullify traditional protections from personal liability on which directors rely, such as exculpation provisions, indemnification provisions, and directors and officers insurance, which are primarily designed to provide protection for directors from claims alleging breach of the fiduciary duty of care.

[1]The judge overseeing the Worldcom case invalidated a provision of the settlement that calculated the director defendants' liability based on their personal net worth (excluding certain assets such as residences, retirement accounts and jointly-held assets). Without this provision, the plaintiffs initially terminated the director portion of the settlement, arguing that future judgments against other defendants in the lawsuit (including deep-pocketed investment banks) could be reduced but subsequently settled with the directors on substantially the same terms.

[2]While the Enron settlement apparently does not include a provision similar to the provision invalidated by the judge in the Worldcom case, the payments are apparently tied to a percentage of pre-tax profits earned by the directors on sales of Enron stock. The settlement is still subject to final approval by the judge overseeing the case.

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Beginning in the mid-1980s, Delaware — the state in which the majority of the largest public companies are formed — and virtually every other state adopted broad exculpation statutes designed to reassure those who serve as directors that innocent failures to discharge their duty-of-care obligations will not put their personal assets at risk. However, these statutes do not insulate directors from liability for breaches of their fiduciary duties of loyalty and, in some states, including Delaware, good faith. They also do not insulate directors from liabilities under other statutory schemes, such as the federal securities laws.

After the proliferation of exculpation provisions in corporate charters, it was commonly believed that the only way a director risked personal fiduciary duty liability was to violate the duty of loyalty through self-dealing. As the thinking went, all other duty breaches (such as being asleep at the switch, making uniformed business decisions, or being ignorant of loss-creating activities within the corporation) were breaches of the duty of care, for which exculpation, indemnification, and insurance would apply. However, this is not a safe assumption under the developing Delaware law of good faith.

Consider, for example, the recent litigation in Delaware involving the Disney board of directors. The Disney case centers on the board's alleged lack of involvement in the employment and subsequent termination of the company's president. The Delaware Chancery Court held, in denying the directors' motion to dismiss, that the facts as alleged raised sufficient doubt that the actions of the Disney directors were taken in good faith. In particular, the court noted that the Disney directors "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude." The court also stated that where "a director consciously ignores his or her duties to the corporation, thereby causing injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct.'"

Arguably, this has always been the law. Indeed, one authoritative commentator, former Chief Justice of the Delaware Supreme Court, E. Norman Veasey, has noted in a recent speech that the "substantive law has not changed. Any change in litigation outcomes has been the result of the fact that board processes have been brought under closer scrutiny by a more precise focus that is influenced by improved pleadings by plaintiffs challenging board governance and actions."[3] Whether or not the changes in litigation outcomes should be unremarkable or unsurprising, they have been noted in the director community.

Director Liability Schemes. While the director liability schemes under federal securities laws and state fiduciary duty laws are different, these recent settlements and cases provide a backdrop for exploring the public policy goals underlying statutory schemes that expose directors to potential personal liability.

For the most part, director liability theories, shaped through legislation and common law, focus primarily on the nature of a director's conduct; when a director is found not to have met the requisite standard, the director is potentially exposed to personal liability for the investors' entire losses. Accordingly, most schemes limiting director liability have focused on narrowing the range of behaviors for which directors may be held liable, and alarms are raised when courts or legislative bodies threaten to broaden the range of behaviors that may yield personal liability. It is of concern, however, that the

[3]"A Perspective on Liability Risks to Directors in Light of Current Events" to Annual Audit Committee Issues Conference, Jan. 19, 2005.

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existing "winner-take-all" approaches to director liability do not adequately serve the public interest, regardless of which director behaviors are proscribed.

Although the demonstrable historical success of American business can be attributed to innumerable causes, investors' willingness to contribute capital to large business organizations depends in large measure on their confidence that directors will provide appropriate direction to, and exercise appropriate oversight over the risk-taking activities of, management. The importance of the private and quasi-public roles played by directors of large business organizations is reflected in the comprehensive regulatory schemes that apply to directors, including state corporate law, federal securities laws (including SOX) and the NYSE and Nasdaq listing standards.

Business enterprises are formed for the sole purpose of assuming and managing risks, in the hopes of earning economic profits on invested capital in excess of the risk-free rate of return. Providing directors with some level of certainty about which behaviors should be avoided allows directors to make strategic decisions regarding a corporation that may involve substantial risk, but also offer substantial reward without fear that a court will second guess their business decision. Without some degree of understanding about the boundaries of liability, directors may be prone to risk-minimizing behavior, which is unlikely to be conducive to creating corporate value over the short or long term. Nor is it appropriate for directors to be held to a standard of oversight that effectively requires director involvement in day-to-day operations — a role best served by management. Conversely, directors should not go unpunished for abdicating their responsibilities or putting their own interests ahead of the corporation's or its shareholders' interests.

Given the scale of modern business enterprises in comparison to the net worth of individual directors, it is not tenable to assert that director liability schemes are intended to provide a meaningful alternative source of recovery for investors disappointed in the results of management's risk-taking activities. Rather, director liability schemes are intended to provide appropriate incentives (beyond direct compensation) for directors to discharge their functions with the expected degree of prudence, care and loyalty, in the best interests of a corporation, its investors and, ultimately, the national economies in which the company participates. If the director liability scheme is, or is perceived by directors to be, potentially confiscatory, the best qualified directors may conclude that their personal interests are best served by risk avoidance — refusing to serve.

Because every corporation, director, and circumstance is different, no liability scheme should arbitrarily cap director liability. However, open-ended director liability, or "financial capital punishment" for directors, is ill-suited to deterring inappropriate behavior by directors and does not adequately serve the legitimate public policy objectives of the American corporate governance structure. There are numerous alternative liability schemes that could be proposed to address the public policy objectives, including limiting director liability to disgorgement of director compensation and investment profits or limiting director liability to particular percentages of director net worth. Although there appears little prospect of immediate legislative reform of director liability standards, fiduciary principles and liability standards regarding directors can and should evolve to keep pace with changing business norms and expectations.

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