

# Outside Directors' Liability: Have WorldCom and Enron Changed the Rules?

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*Until now, it was rare for an outside director to have to pay money out of his or her own pocket to settle a shareholder lawsuit. The recent multimillion-dollar payouts by former directors of WorldCom and Enron may have changed all that, but probably not by much.*

In January of this year, former outside directors of WorldCom and Enron agreed to pay a total of \$31 million out of their own pockets to settle securities class action lawsuits stemming from two of the largest corporate governance scandals in U.S. history.<sup>1</sup> Directors' and officers' insurance paid an additional \$36 million to settle the WorldCom suit, and \$155 million to settle Enron. While there is nothing unusual about the insurance payments, the directors' out-of-pocket payments—\$18 million in the case of WorldCom and \$13 million with Enron—are extraordinary, and surely have outside directors and those considering board seats thinking twice about the desirability of these positions.

We consider here the following key questions that these settlements raise. Why has out-of-pocket liability for outside directors been so unusual? Do WorldCom and Enron signal a sea change? Will these settlements have a salutary effect on the incentives of outside directors to be vigilant? Will the settlements lead to a counterproductive exodus from the boardroom? The ways in which public pension plans and other institutional investors respond to the WorldCom and Enron deals will influence the answers to the last three questions. We conclude by recommending a response to these issues that we believe will strike a reasonable balance.

## Why Is Out-Of-Pocket Liability So Unusual?

Outside directors of public companies face a daunting array of legal obligations. Under federal securities law, directors are potentially liable whenever a company makes misleading public statements. Under corporate law, they can be sued for

failure to adequately oversee management. Under pension law, directors can be liable if the company's retirement plan suffers markedly as a result of overinvestment in the company's own shares.

Nonetheless, outside directors almost never end up paying out of their own pockets. Plaintiffs are often successful in obtaining settlements in cases where outside directors are named as defendants. There are even occasional trials in which directors are held nominally liable, in the sense that the directors lose, but all damages and legal expenses are paid by the company and/or directors' and officers' (D&O) insurance. The famous 1985 case of *Smith v. Van Gorkom* is one example, and a 2004 Delaware case, *Emerging Communications*, is another. Damages, however, almost never come out of the outside directors' pockets. Prior to WorldCom and Enron, our research uncovered only one shareholder suit in which outside directors made an out-of-pocket payment as part of a settlement.

The details of settlements are generally kept confidential, so we may have missed a few instances of out-of-pocket liability. We don't think so, however, because the rarity of out-of-pocket liability for outside directors is a predictable result of legal rules, the terms of D&O insurance policies, and plaintiffs' incentives to settle rather than try cases.

To start, substantive and procedural rules governing corporate and securities law claims make it difficult for a plaintiff to survive an outside director's motion to dismiss, and cases that get beyond that threshold still face liability and damage rules that protect outside directors. Take, for instance, lawsuits brought under Section 11 of the

Securities Act of 1933 for misstatements in offering documents, where outside directors arguably face greater risk than in any other type of litigation. In a lawsuit brought under Section 11, a corporation's outside directors will be sued along with the corporation itself, the inside managers, and often other parties such as the company's investment bankers and auditor. The applicable law makes the outside directors the least attractive of these defendants. Their damages will be based on their relative culpability, which is unlikely to be high since they are not involved in day-to-day management decisions. In addition, the company is strictly liable whereas the outside directors (along with other individual defendants) have a due diligence defense. As a result, plaintiffs generally have little reason to pursue outside directors other than to pressure the company to settle.

Of course, outside directors confronted with a lawsuit will incur legal costs even if a case is ultimately dismissed, but except in cases of serious misconduct the company will indemnify the outside directors for their expenses, and the company's D&O policy will protect them as well. Between indemnification and D&O insurance, amounts the outside directors pay in settlement would likely be covered as well. While indemnification is subject to a "good faith" condition, D&O insurance is not. Furthermore, D&O insurance is available when a company is insolvent.

The primary limitations on D&O coverage are policy exclusions for claims in which a defendant engaged in "deliberate fraud" or received "illegal profits." These exclusions rarely apply to outside directors, given their lack of managerial responsibilities. Gaps in outside directors' coverage have arisen—such as nonseverability when the actions of management have rendered a policy void. But as those gaps open, D&O insurers write new policies that close them, for a price.

A pivotal byproduct of the set of protections just outlined is that plaintiffs, defendants, and insurers all have strong incentives to settle suits before trial on terms that leave outside directors' personal assets untouched. Except in rare cases, a company's assets and D&O insurance are the pots of gold targeted in a lawsuit. Especially when a trial could expose them to a risk of out-of-pocket liability, directors will welcome a settlement that is entirely funded by the company and the insurer. Plaintiffs and their lawyers, who work on a con-

tingency fee basis, will be similarly inclined since a trial is risky and time-consuming—particularly if there are appeals, which there surely will be if outside directors face an out-of-pocket payment.

If a company is insolvent, and thus unavailable to pay damages directly as a defendant or to indemnify directors, a plaintiff's incentive to settle within D&O policy limits increases. If a case goes to trial, the D&O policy funds both sides' expenses through appeals and final judgment. Thus, taking a case to trial will substantially dissipate the principal "deep pocket"—the D&O policy—from which a plaintiff hopes to collect.

Insurers, in turn, will likely go along. Due to legal rules and a fear of alienating future customers, they rarely reject a settlement to which the plaintiff and the defendant directors have agreed. Indeed, we know of no shareholder suits since 1990 (as far back as we looked) in which insurers have forced a defendant to go to trial.

At least until WorldCom and Enron, the logic that emerged from this complex of legal rules and insurance coverage was one in which cases virtually always settled with no money coming out of the pockets of outside directors. The window of vulnerability for outside directors, where this logic did not hold, required the following conditions: significant evidence of director culpability; an insolvent company; inadequate D&O insurance, either because the insurer can plausibly deny coverage or because damages greatly exceed the policy limits; and outside directors who are wealthy enough to justify the risks to a plaintiff of taking a case to trial.

Without this "perfect storm," outside directors had little reason to fear that they would have to pay personally as a result of litigation. Rather than going to trial to try to recover amounts above the insurance policy limits, and hence put outside directors potentially at risk for out-of-pocket liability, plaintiffs instead settled for amounts within the D&O policy. The question of the day is whether the WorldCom and Enron settlements reflect a change in this logic.

### **Do WorldCom and Enron Signal a Sea Change?**

WorldCom and Enron appear to meet the conditions constituting a perfect storm: while the outside directors did not participate actively in any of the frauds, their oversight seems to have been seriously inadequate; the companies were insol-

vent; although the companies had large D&O policies, the potential damages far exceeded the coverage limits; and the outside directors were collectively wealthy. Because of these factors, the plaintiffs could have credibly threatened to go to trial with a reasonable chance of getting a judgment exceeding the policy limits, and bankrupting the outside directors.

In both Enron and WorldCom, however, there was more—namely an explicit agenda on the part of plaintiffs to get outside directors to pay out of their own pockets. In Enron, the rationale for extracting personal payments was to retrieve trading gains from outside directors who sold Enron shares during a time in which share prices were high as a result of the fraud. The moral of that settlement may thus merely be that irresponsible outside directors must disgorge profits unwittingly gained from a fraud they failed to detect or deter.

In the case of WorldCom, the goal was more ambitious. The lead plaintiff wanted to send a general “message” to outside directors to do their jobs properly, or else. In announcing

the settlement, Alan Hevesi, Comptroller of the State of New York and trustee of lead plaintiff New York State Common Retirement Fund, stated: “The fact that we have achieved a settlement in which these former outside directors have agreed to pay 20 percent of their cumulative personal net worth sends a strong message

to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent. We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud.”<sup>2</sup>

Hevesi’s approach to the WorldCom settlement, if it becomes widely adopted, could significantly change the litigation landscape for outside directors. While the elements of a “perfect storm” must still be present to some degree, a plaintiff that sees independent value in having outside directors pony up will be more willing to risk a trial than plaintiffs focused purely on maximizing the recovery in a particular case. Consequently, even if some of the ingredients of a perfect storm are absent (e.g. the evidence against the directors is fairly weak, or outside directors are not all that wealthy), such a plaintiff can credibly threaten a trial, in which case outside directors will feel pressure to settle for an out-of-pocket payment.

If other lead plaintiffs share Hevesi’s motives, more outside directors will have to make the difficult choice between a significant out-of-pocket settlement payment and a potentially bankrupting judgment after trial. An increase in out-of-pocket liability risk for outside directors would necessarily follow.

#### **Will WorldCom and Enron Have a Beneficial Effect on Outside Directors’ Incentives?**

Some have praised the WorldCom and Enron settlements, predicting that directors’ fears will induce greater vigilance in the boardroom. Outside directors may indeed worry more about how good a job they are doing. But outside directors already have incentives to be vigilant for reasons other than liability. They generally own stock, which will be worthless if the company becomes engulfed in a scandal. Indeed, WorldCom’s outside directors reportedly lost \$250 million as a result of the company’s collapse. Outside directors also have reputations at stake. If a scandal occurs on their watch, they will suffer socially and professionally. A lawsuit will compound the problem, regardless of whether the directors bear out-of-pocket liability or not. Moreover, being a defendant in a lawsuit entails considerable time and aggravation.

Outside directors fearing financial ruin will no doubt be more careful than directors feeling immune to out-of-pocket liability will be. But by how much? We simply don’t know. And there can be too much of a good thing. With jittery directors at the helm, prudent caution can readily transform into counterproductively defensive decision making and even paralysis in the boardroom.

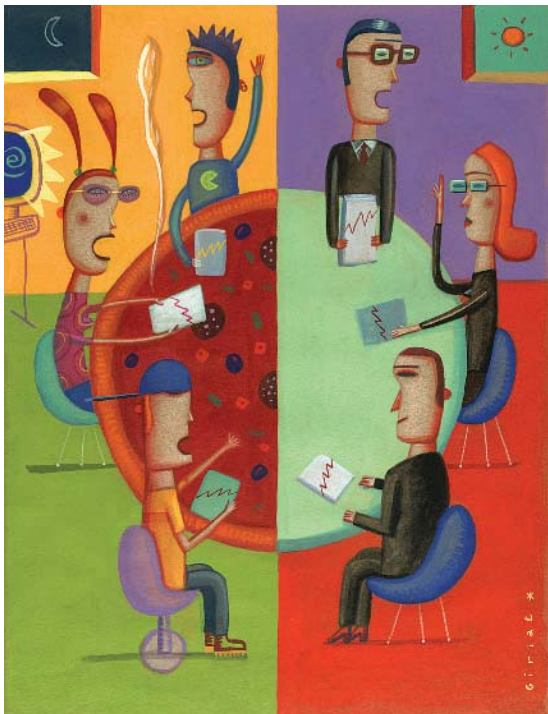


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### Will the Settlements Deter Capable People From Serving on Boards?

Despite the importance of outside directors and the considerable amount of time now required of them, directors' fees are not very high by the standards of people who generally take these positions—about \$140,000 for the largest companies and a lot less for smaller ones. Perceived liability risk would not have to increase much to induce attractive boardroom recruits, such as chief executives of major public companies, to decline directorships.

Outside directors already overestimate the likelihood of out-of-pocket liability, and frequently cite the fear of liability as a reason not to serve. According to surveys we have conducted, even prior to the WorldCom and Enron settlements outside directors believed on average that out-of-pocket liability occurs in about 5 percent of shareholder suits. The actual number is far lower—only a few instances out of several thousand cases—but it is the perception of liability risk that affects directors' willingness to serve.

The WorldCom and Enron settlements will increase liability fears among outside directors. This would be a natural consequence of any high-visibility out-of-pocket payment. The perception of liability risk in the wake of WorldCom and Enron, however, is compounded by the political overtones associated with the lead plaintiffs' being public entities. Even if politics played no role in these cases, one can reasonably be concerned that political considerations unrelated to corporate governance will cause lead plaintiffs in the future to insist on personal payments by outside directors. Especially in light of the praise for the Enron and WorldCom settlements, others making litigation decisions on behalf of public entities may think "If Alan Hevesi made the outside directors pay in WorldCom, I'll look pretty bad if I don't do so as well."

### What Public Pension Plans Should Do Now

The ideal outcome of the WorldCom and Enron settlements would be an enhancement of incentives for outside directors to be vigilant, without

scaring capable people away from boards. For this to happen, public pension plans and other institutional investors must refine the "message" of these settlements.

At this point, getting a precise fix on the WorldCom and Enron settlements is difficult. Were they exceptional deals well tailored to exceptional failures of oversight? Or do they signal a general desire on the part of lead plaintiffs to go after the personal assets of outside directors whenever a management failure has gone undiscovered? Or is the "message" even one of leniency? After all, the WorldCom and Enron directors' personal payments left all of the directors with considerable wealth, and some Enron directors did not pay at all, despite the fact that an adverse judgment probably would have bankrupted each and every one of them.

Given the central corporate governance role outside directors play—a role that institutional shareholders are largely responsible for placing them in—public pension plans should not allow this uncertainty to persist. Instead, they should articulate explicitly their stance on out-of-pocket liability.

In our view, the position they take should be as follows. First, plaintiffs should go after the personal assets of outside directors only in cases of deliberate self-dealing or egregious failure of oversight. Second, while in cases of deliberate self-dealing there should be no limit as to what they seek from the directors, in cases of lax monitoring, plaintiffs should—as in Enron and WorldCom—demand out-of-pocket payments only in amounts that leave personal wealth substantially intact. Precisely what the limits should be we leave for another day.

For now, the key is for public pension funds and other institutional investors to formulate and publicize a basic settlement strategy that provides some scope for out-of-pocket liability for outside directors but makes due allowance for the legitimate fears of those serving on the boards of public companies. With this sort of follow-up, the Enron and WorldCom settlements could indeed foster better corporate governance. ■

1. The deal struck was subject to judicial approval. At the time of writing, no ruling had been made.

2. Press release, Office of the New York State Comptroller, January 7, 2005, <http://www.osc.state.ny.us/press/releases/jan05/010705.htm>. At press time, two former directors were still negotiating with the plaintiffs.