DM EXTRA!

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Frontier Justice? Recent D&O Settlements Prompt Rugged Individualism—and Calls for Realism

Director Summary >

For directors, the New Year has come in with a bang—two of them. These are the settlements heard 'round the world. It has come to light that directors of **WorldCom** and **Enron**, after months of negotiations, have agreed to pay settlement amounts out of their own pockets.

What were these 20 directors thinking when they did this? Apparently they were trying to avoid making even larger out-of-pocket payments later—payments that neither their board's D&O insurance policy nor their company's indemnification policy would cover.

Are these unique cases involving only the WorldCom and Enron situations, or is there a new frontier justice at work? Clearly, the plaintiffs in these cases wanted to make an example of individual directors in a way that courts had not done to their satisfaction—but does this actually amount to a trend, or is it an anomaly? **> This DMX explores the recent WorldCom and Enron settlements and their potential impact on D&O insurance and indemnification, and on director compensation and evaluation.**

(For a more comprehensive look at D&O liability and insurance, see the January 3, 2005, *DMX*, "Caution: D&Os Working—Reducing Liability Exposure in 2005," http://www.nacdonline.org/dm/NACD-DMXJan3-2005.pdf, and November 5, 2004, "White Collar Crime Crackdown," http://www.nacdonline.org/dm/NACD-DMXNov5-2004.pdf. Also, for expert legal commentary on the subject of D&O liability in the new climate, see http://www.weil.com/wgm/pages/Controller.jsp?z=s&sz=ms&f=governance)

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

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What Happened

WorldCom

On January 7, 2005, in a press conference in New York City, **New York State Comptroller Alan Hevesi** announced that 10 of 18 former **WorldCom** directors had tentatively agreed as individuals to settle their part in a case involving former shareholders of WorldCom (now **MCI**). The announcement followed earlier leaks to the press. An eleventh director is on the verge of participating, and a twelfth director, the former outside chairman, is holding out because of questions about insurance coverage.[1] Six will definitely not be part of the settlement. The 10 directors involved in the settlement agreed to pay a total of $18 million of their own money as part of a $54 million settlement. (In addition to the $18 million from directors' own pockets, plaintiffs will also receive $36 million from insurers, per the WorldCom D&O policy.) The $18 million is calculated as the sum of 20 percent of each of the directors' aggregate net worth, not counting their primary residences and retirement accounts, plus the fees that directors earned during the period of the WorldCom fraud (1999–2002). The directors settled in advance of trial scheduled in the **Southern District of New York** February 28, 2005, **Judge Denise Cote** presiding. Banks in the case have protested the settlement. They want the directors to go to trial, something that neither the plaintiff shareholders nor the defendant directors want.

Directors reportedly acted under the advice of their counsel, **Paul C. Curnin**, a lawyer at **Simpson Thacher & Bartlett LLP**. This settlement occurred at the insistence of Hevesi, who was lead plaintiff in the case as trustee of the **New York State Common Retirement Fund (NYSCR)**. His fund lost an estimated $300 million in the WorldCom bankruptcy. NYSCR is represented by two New York law firms, **Bernstein Litowitz Berger & Grossmann LLP** and **Barrack, Rodos & Bacine LLP**. (Separately, on January 12, the two firms announced a $973 million settlement with the **McKesson** board—the third largest securities litigation settlement in history.[2] The settlement took place after one year of discussion mediated by **Magistrate Judge Edward Infante**, retired.)

Enron

On January 8, 2005, a new set of headlines announced that 10 former directors from **Enron** had agreed to pay a total of $13 million of their own funds as part of a $168 million settlement pertaining to the December 2001 bankruptcy of the energy giant. The settlement agreement—which did not involve Enron executives, only Enron directors—actually occurred in October 2004, but was not announced until January, after the insurance payment details got ironed out. The amounts, which reportedly involved a $5 million payment from one of the directors, were determined as 10 percent of pretax proceeds the directors received from selling shares during their tenure. The Enron stock sell-offs occurred prior to disclosures that drove the price of Enron shares down from their previously inflated values. This was the fourth settlement in the case so far, for a total of $500 million in settlements. The three prior settlements were with Enron's accountant (**Arthur Andersen**), commercial bank (**BankofAmerica**), and investment bank (**Lehmann Brothers**). Last May, Enron directors agreed to pay $1.5 million in settling a suit with the **Department of Labor**, but this payment was covered by insurance. This latest Enron settlement agreement requiring personal payments from directors is subject to approval from the bankruptcy court.

Approximately $13 million of Enron's insurance money has been set aside to cover legal fees for former Enron executives—and may not be used to pay fines or settlements. In the unlikely event that any of that amount remains once all litigation is completed, it will be turned over to the plaintiffs. (It is probably more likely that former executives will have to rely on personal insurance to pay the amounts above and beyond the $13 million.) The rest of the money is already allocated and is thus now depleted with respect to defense cost reimbursement. The money is going to shareholders, not creditors. Of the $187 million remaining, $155 million (83 percent) will go to former shareholders, and $32 million (17 percent) will go to Enron creditors. This allocation represents a significant victory for the shareholder litigants, since under bankruptcy law, creditors normally have priority over shareholders when companies are in the zone of insolvency.[3]

Frontier Justice?

This may herald a "new frontier" for director liability, in which shareholder litigants are accomplishing goals through settlement that they cannot otherwise achieve in court or through proxy voting. In the *DMX* of January 5, 2005, we reported that some plaintiffs were using the leverage of lawsuit settlements to force governance reforms that they could not achieve through shareholder resolutions. In the case of Enron, the plaintiffs used a looming jury trial to accomplish the goal of disgorgement. Enron directors were charged with negligence, not insider trading.[4] The settlement, however, seeks a satisfaction of that claim, just as though it had been successful.

"We thought it was very significant that we got a disgorgement of the insider trading profits that we had no legal way to reach," said **William Lerach** of **Lerach Coughlin Stoia Geller Rudman Robbins LLP**, speaking to the *Wall Street Journal*.[5]

Plaintiffs wanted to make an "example of the directors" involved.

WorldCom and Enron directors may have opted for the expensive settlement in order to preserve their reputations. Although agreeing to a settlement is not as favorable an outcome as getting vindicated in court, it is preferable to getting found liable in a civil court or, worse yet, guilty in a criminal court. And in these cases, reputation was of utmost importance.

In the case of WorldCom, directors who agreed to pay personally included several former CEOs of major companies, a former law school dean, a former Secretary of the Army under **President Jimmy Carter**, and a past president of the **National Association of Securities Dealers** who had published on the subject of corporate governance. In the case of Enron, prestigious directors included the former chair of the **Commodities Futures Trading Commission**, who was the wife of a Senator who had run for President, and a well-known accounting professor and dean.

Individual Accountability

Plaintiffs were quoted as saying they wanted to make an "example of the directors" involved.[6] Individual accountability was the theme of an October 2004 keynote address by **U.S. Deputy Attorney General John Comey** at the NACD annual conference. As reported in a previous *DMX* (November 5, 2004) Comey explained that the main purpose of his Corporate Fraud Task Force was to deter white collar crime by prosecuting "high-profile" cases against both companies and individuals. At the time Comey spoke, members of Comey's Task Force had charged some 900 violators and secured over 500 corporate fraud convictions, including at least 25 former CEOs. Many of these convictions led to prison sentences. In addition, Task Force members have frozen tens of millions in assets.

In a similar vein, the **Securities and Exchange Commission (SEC)** is not limiting itself to going after corporations, but is also going after individuals. "There's nothing more important from our perspective in what we do than trying to hold accountable individuals. We think it's important to punish both individual and corporate wrongdoers. Effective deterrence requires personal accountability," **Steven Cutler**, chief of enforcement for the SEC, told the *The Wall Street Journal* last week. To veteran watchers of business, this statement was not news. Governance history is full of examples of managers and advisors being punished as individuals. So far, however, it has been rare to go after independent directors. The WorldCom and Enron cases are new in this regard.

Impact on D&O Insurance and Indemnification

If in fact a new kind of frontier justice is at work, then no amount of insurance could have prevented the settlements. That is, if the plaintiffs wanted to make an example of the directors, plaintiffs would not have been satisfied with payments from insurers. Nonetheless, all director eyes are on insurance, and with good reason.

Lou Ann Layton, managing director and national client advisory practice leader at **Marsh USA Inc.**, a leading insurance brokerage firm, notes, "While these issues are not directly related to the D&O coverage, they should highlight the need for all directors to review the existence and breadth of their D&O coverage." A review of the WorldCom and Enron insurance packages suggests some areas for focus—namely coverage amount and reimbursement of legal costs.

The WorldCom insurance amount payable for the relevant period was $100 million, but nearly half of it has gone out in legal fees during an exhaustive process of settlement. (See box on page 4.) The Enron policy purchased for the relevant time period offered $200 million in D&O insurance coverage. Enron directors and officers had the first claim on this money to pay for all litigation-related costs—up to $100 million.

With such a large amount of insurance available, one might ask why the directors and officers did not simply go to trial and take their chances. After all, historically, directors have never had to pay out of pocket. So, again, why the settlement? In the case of WorldCom, it is widely reported that Hevisi of NTCRF insisted on the payments.[7] In the Enron case, plaintiff lawyers (Lerach Coughlin) threatened to try to prevent the promised payout on the grounds that the beneficiaries could still be blamed in bankruptcy court for participating in the fraud by failing to prevent it. The directors apparently believed that such a charge could receive a sympathetic hearing. Recent insurance payout trends would appear to support this belief. (According to **Tillinghast**, a **Towers Perrin** subsidiary that tracks D&O payment trends, a significant percentage of payouts from D&O insurance policies in recent years, both from legal judgments and from out-of-court settlements, have come in response to allegations of accounting fraud.) http://www.towersperrin.com/tillinghast/publications/reports/2004_D_O/2004_DO_Exec_Sum.pdf

Is the solution to simply buy more insurance? More insurance may be part of the answer, but it is not a complete solution, says **Paul Rauner**, vice president of **NASDAQ Insurance Agency, LLC**.

An Inside View: Interview with Leonard Barrack, Lead Counsel for Plaintiff NYSCR In re: WorldCom Securities

"Arduous, intense, and extensive negotiations took place under supervision of **Magistrate Judge Michael Dollinger** of the **U.S. District Court of the Southern District of New York** over a period of approximately 18 months," says **Leonard Barrack**, the senior partner at **Barrack, Rodos & Bacine**, in an interview with *DMX*.

His law firm is co-lead counsel with **Bernstein Litowitz Berger & Grossmann**, the law firm that helped negotiate the settlement with the outside directors at **WorldCom**. "Each side walked away from the table several times throughout the negotiations, only to come back and restart them later," he recalls. Outside directors initially resisted paying any personal dollars into the settlement fund, but decided to do so in light of the size of the loss, the magnitude of the fraud, and the fear that they might lose a lot more than their director fees and 20 percent of their net worth.

When asked about the similarities or differences between the WorldCom and **Enron** settlements, Barrack points out that even though the WorldCom and Enron directors settlements were announced within a couple of days of each other, it is the WorldCom directors who are really "feeling the pain."

Barrack notes that the WorldCom directors (unlike the Enron directors) have to pay much more than what they earned during the period of the company's fraud (1999–2002). WorldCom directors have to disgorge their director fees and make individual payments based on their *own net worth* as well. "This could be a precedent for the long term," says Barrack.

According to Barrack, WorldCom insurers sought to have the D&O policies declared void, based on the fact that the policy application was signed by two company officers that were later indicted for criminal fraud. The plaintiffs convinced the insurers to pay by negotiating a deal whereby insurers paid approximately 50 cents on the dollar of the funds remaining available under the D&O policies.

In closing, Barrack had these words. "Directors and shareholders are on the same side. A main function of an outside director is to protect shareholders, and many directors do just that. But if directors fail to do that job, we want them to feel it. The good news is that these settlements will incentivize board members to act more vigilantly. Directors will be more likely to ask tough questions, ask for supporting information, and not rubber-stamp the decisions of management. Is this the wave of the future? Maybe so—but a fully empowered, fully informed board is highly unlikely to wind up in a situation like WorldCom."

"It wouldn't make economic sense for every company to buy enough insurance to cover an Enron or a WorldCom," says Rauner. He likens these situations to highway accidents. "What kind of car would you buy to be safe in a 20-car pile-up? A tank? I don't think so. The lesson is to drive safely—be able to demonstrate that you meet and exceed best practices as a director and have enough of the right kind of insurance

He notes two points among others:

- Directors need to make sure that the coverage their company buys has *favorable terms and conditions*, especially the "severability" of the application language. (A severability clause, in theory, is policy language that allows an insurer to rescind a policy with respect to culpable insureds while leaving it in place for innocent insureds.) Ideally, policies should be non-rescindable, notes Rauner, at least with respect to non-indemnifiable losses. (Non-indemnifiable losses are losses that a company cannot pay on behalf of its directors/officers either because a) the company is insolvent, b) indemnification is not allowed by law as in certain derivative claims, or c) the defendants are found to have acted in bad faith.)
- Furthermore, independent directors should ask about *allocation*—whether part of the D&O program can be allocated to them, as distinct from insurance covering inside directors, management, and the company. There are two possible options.
  - — First, directors can ask for a policy to cover outside directors as a group (as distinct from all directors). To date, such a policy does not yet exist, but there could be a new demand for such policies—especially in light of the new movement to define the role and leadership of independent directors. NACD member and speaker **Betsy Atkins**, a past **HealthSouth** director and a current director with **Reynolds American Inc.** and three other public companies, has stated that directors could benefit from having such a policy.[8]
  - — Secondly, there are also policies that cover *individual directors*. These policies have been available from major insurers for about two years. They are expensive, but in the current climate, they are worth exploring.[9]

Rauner's agency conducts complimentary D&O insurance evaluations for all NASDAQ-listed companies, and for all NACD member companies.

Impact on Director Compensation and Evaluation

These two settlements are likely to have an immediate impact on director compensation and self-evaluation.

Director compensation is likely to increase. Directors will want to receive more money for their services, if they face virtually uninsurable risk of loss. This is especially true since directors are taking on fewer board seats. **Spencer Stuart** research shows the typical CEO of a top 200 company has dropped from serving on one or two boards five years ago (1.6) to serving on only one today (0.99). Also, directors are subject to more rules through Sarbanes-Oxley and stock exchange listing rules.

Edward Archer, senior vice president at **Pearl Meyer**, predicts a rise to the "$200,000 level" at the very largest corporations. "Director pay has been rising steadily by 11 percent per year in the largest firms for many years. It went flat recently only because of a decline in stock values," says Archer. "In 2005, I predict a bigger jump in total compensation, especially for very large public companies." For pay trends in companies of all sizes, see http://nacdonline.org/publications/pubDetails.asp?pubID=227

Director evaluation could change, too. In evaluating their performance as boards and as individuals, directors are likely to add a liability component. According to **Chuck ReCorr**, president of the **Research Triangle Chapter** of the NACD, and a member of the NACD board of directors, "Directors are all asking, are we next? A director liability exposure check is likely to become part of every evaluation process." The Research Triangle area has a relatively high exposure to D&O liability, because of the presence of biotech companies there. Of all industry sectors, biotech companies are the most prone to getting sued, according to Tillinghast.

What's Next?

Indeed, in public companies of all sizes and in all sectors, directors may be asking, "Are we next?" In some scandal-plagued companies, the answer may be, yes. Lawsuits pending against **HealthSouth** and **Nortel Networks** name outside directors, so more headlines may be coming soon.

Will this development make it more difficult to recruit and retain directors? NACD president **Roger Raber** believes that such concerns are overblown. Speaking to the *New York Times*, he said, "In the wake of corporate scandals over the last few years, potential directors are much more cautious about joining boards of companies in trouble, but they are not entirely avoiding serving on boards."[10] Before accepting new board seats, directors are simply doing more "due diligence."

Sources interviewed for this *DMX*, both for quotation and off the record, cautioned against overreaction. All agreed that directors who conduct themselves conscientiously have little to fear. As one interviewee put it, "The sky is not falling. The fundamentals still apply." ■

Endnotes

1 Shawn Young, "Another WorldCom Ex-Director Is on Verge of Settlement in Suit," *The Wall Street Journal,* January 12, 2005, p. B6.

2 The first largest was a 2000 Cendant settlement of $3.2 billion, and the second largest was a Citigroup settlement (pertaining to WorldCom) of $2.65 billion.

3 For general legal principles, see Martin J. Bienenstock and Robert L. Messineo, "When Financial Trouble Comes: A Guide for Directors," *Directors Monthly,* September 2001. For other more recent articles, see *Directors Monthly* archives under "troubled company": http://www.nacdonline.org/publications/dmSearch2.asp?t=Troubled+Company+Oversight.

4 The plaintiffs in the Enron case had accused Enron directors of insider trading, but could not prove their case in court, which would not hear this argument. The case against the Enron directors was based on negligence—for signing financial statements that later turned out to be false. Plaintiffs successfully argued that the directors should have been more attentive.

5 See Kurt Eichenwald, "Ex-Enron Directors Chip in on Settlement," *The Wall Street Journal*, January 8, 2005.

6 Gretchen Morgenson, "10 Ex-Directors From WorldCom to Pay Millions," *The Wall Street Journal,* January 6, 2005.

7 "In the case of the WorldCom settlement…Hevesi refused to settle unless the former directors personally paid damages." Joann S. Lublin, "Directors Are Getting the Jitters," *The Wall Street Journal,* Thursday, January 13, 2005, p. B1.

8 Lublin, p. B1.

9 For a fairly recent discussion of these policies, see http://www.worth.com/Wealth/Risk-Review/ subarticles/Insuring-Our-Personal-Security-Directors-Dilemma.asp. According to this article, as of mid-2004, AIG (National Union) and Chubb had offered such policies for 18 months, but only about 100 had sold.

10 Johathan D. Glater, "A Big New Worry for Corporate Directors," *New York Times*, January 6, 2005, p. C1.