UPDATE

Director Settlements and Liability after WorldCom and Enron

In highly publicized settlements last month, former WorldCom and Enron directors agreed to contribute personal funds to settlements of securities class actions brought by investors who lost billions of dollars when the companies collapsed. Soon after the WorldCom settlement was announced, the investment bank defendants in the case challenged the settlement on the grounds that, among other things, it could leave them with more than their fair share of liability. Earlier this month, the judge overseeing the WorldCom case invalidated a provision of the settlement that calculated the directors’ liability based on their personal net worth. Without this provision, plaintiffs argued that judgments against the other defendants could be reduced, and terminated the settlement. It is reported that the Enron settlement does not contain a provision similar to the one that put an end to the WorldCom deal, but the Enron settlement remains subject to court approval.

The termination of the settlement in WorldCom could make similar settlements with directors difficult to reach. Plaintiffs will not want to limit the amount of recovery against investment banks and other “deep” pockets, and may not be inclined to settle with individuals. The circumstances surrounding WorldCom and Enron, however, are extraordinary, and the possibility of director settlements in the future, as well as any resulting personal liability of the directors (whether as a result of settlements or jury decisions), should be analyzed in that context. In considering the impact the WorldCom and Enron cases will have on future settlements and the personal liability of directors, keep in mind the following:
These cases were the result of massive corporate meltdowns, and the accounting improprieties at these companies were substantial and egregious. Most observers credit (or blame) them for producing the Sarbanes-Oxley Act. Specific provisions of Sarbanes -- including CEO and CFO certification of internal controls and financial statements, the prohibition on loans from corporations to officers and directors, and increased penalties for document destruction -- can be traced to the circumstances of the cases.

When WorldCom collapsed in 2002, it was the largest bankruptcy in history, purportedly the direct result of one of the largest corporate accounting frauds ever. The fact that both WorldCom and Enron had filed for bankruptcy made contributions by the companies themselves impracticable.

In June 2003, two reports (one issued by WorldCom’s newly appointed audit committee and another by the bankruptcy court) found that WorldCom’s former board of directors did not function in a way that would allow it to discover or prevent the company’s troubles. The reports concluded that the board was passive and detached, citing various examples such as the limited number of board meetings, the board’s approval of multi-billion dollar transactions with little discussion and its approval of hundreds of millions of dollars in personal loans to CEO Bernard Ebbers. These findings put the directors in an extraordinarily difficult litigation posture that they otherwise would not have had to face if the settlement had not been terminated.

At the time the fraud was occurring at WorldCom, the company was selling securities to the public. In a ruling prior to the settlement, the judge denied the outside directors’ motions to dismiss the complaint including allegations related to the directors’ signing of an allegedly fraudulent registration statement. By keeping alive for trial the registration statement claim, the outside directors are exposed to liability on a claim where the plaintiffs need not show that the directors acted with any malicious or fraudulent intent, but rather, the outside directors will have to demonstrate that they conducted a thorough review of the registration statement before signing it and could not have known about any misstatements. Had the settlement not been terminated, the directors would not be required to demonstrate their diligence.

In the Enron settlement, the insurance carriers will pay most of the settlement amount ($155 million). The directors’ contribution of $13 million is reported by the plaintiff to be ten percent of their pretax profits from sales of Enron stock during the period in which the fraud was occurring. These directors still retained a total of $117 million in stock profits.

The defunct WorldCom settlement and the Enron settlement do not suggest the creation of any new substantive laws or obligations on corporate governance, and may not signal difficulty in obtaining future settlements. Federal securities laws provide that directors involved in cases involving the sale of securities (like the WorldCom case) can be personally liable in an amount equal to what is determined to be their fault or
responsibility. The $13 million that was to be paid by the WorldCom directors under the settlement seemed insignificant -- literally billions of dollars of losses were suffered by the WorldCom shareholders. Settlements in cases where the losses are not so staggering may be able to more appropriately reflect the responsibility and resulting liability of the defendants.

Additionally, the WorldCom and Enron settlements do not suggest a shift in director duties and risk. Corporate directors certainly know that they have fiduciary duties. In making business decisions, directors are required to review and consider all material information reasonably available (the so-called “duty of care”), in a manner the directors believe to be the best interests of the corporation (the so-called “duty of loyalty”). The federal securities laws have differently articulated standards, but, in the end, operate to impose liability only if a director failed to act with a customary level of care. Directors have always had the risk of personal liability if they breached their duties to the corporation and its shareholders. It is, however, very unusual for individual defendants to contribute personal funds to satisfy securities class action settlements or jury verdicts. Director indemnification and insurance coverage will likely protect against any liability that could be asserted against a director in his or her capacity as a director as long as the director has exercised business judgment and made a good faith attempt to fulfill the fiduciary duties they owe to the corporation and its shareholders.

Most companies are not WorldCom or Enron, and most boards have always been aware of their responsibilities and acted responsibly. The key from a director’s perspective continues to be process -- the law is clear that a board that follows a normal, thorough decision-making process and does not have officers or board members with undisclosed self-interests will be able to defend challenges to its functioning. This focus on process requires both that the directors engage in active discussion of matters before them and that their decisions be made only after a reasonable period of thorough consideration of all information readily available. In order to establish a good record that the board acted in good faith in performing its duties, the directors’ consideration and approval process should be carefully documented to facilitate judicial review if litigation does occur.

The foregoing is a highly condensed and generalized discussion of some key provisions of the settlements and cases, and may be affected by subsequent administrative, judicial and other interpretation.

As always, please feel free to call your regular Jones Day contact if you have any questions or would like to discuss duties of directors or the recent settlements and their implications further.

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