

Outside Director Liability: Increased Risks and Practical Considerations

As a result of a host of recent judicial and regulatory developments, Outside Directors face a dramatically altered liability environment. A wave of corporate scandals, the enactment of the Sarbanes-Oxley Act, and a changing cultural perception of the responsibilities of individuals who serve on corporate boards present Outside Directors with increased exposure to shareholder claims and enforcement actions. Recent cases such as *Enron* and *WorldCom* - in which settling individuals were barred from seeking indemnity or insurance reimbursement for their settlement payments - add a particularly ominous element to this heightened liability threat.

The *Enron* and *WorldCom* settlements unquestionably raise the stakes for Outside Directors. The SEC's enforcement posture provides an added measure of concern.

It is clear that plaintiffs' lawyers and regulators intend to pursue Outside Directors aggressively. Under the circumstances, it is hardly surprising that the U.S. Chamber of Commerce, in a special report reviewing securities litigation reform, concluded that "[t]hese developments are deterring qualified individuals from service as Outside Directors."¹

This article examines the recent developments concerning Outside Director liability, presents some practical considerations in light of the heightened risk, and reviews important insurance considerations.

[It] is now beyond question..., the potential liability risks of Outside Directors are not remote, but are abrupt and real.

The *WorldCom* and *Enron* Settlements

In a recent development that has caused great consternation in boardrooms nationwide, twelve former *WorldCom* directors and ten former *Enron* directors agreed to pay significant portions of their personal assets, without recourse to indemnity or insurance, to settle allegations that they had failed to detect financial wrongdoing at the companies on whose boards they served. The directors' out-of-pocket payments -- \$24.75 million in the case of *WorldCom* and \$13 million with *Enron* -- are extraordinary. The personal contributions in the *Enron* settlement represented a portion of the profit that the directors realized on their sale of company stock prior to *Enron's* collapse. By contrast, the *WorldCom* settlement amount was made not by reference to trading profits, but in relation to the individual defendants' personal net worth -- the individuals' settlement contribution represented approximately 20% of the Outside Directors' net worth (excluding residence and retirement accounts).

The *Enron* settlement involved one particularly disturbing feature. The individual directors' \$13 million settlement contribution was in addition to a \$168 million contribution from the company's D&O insurance program. The

The Sights

Inside:

Changes in SEC
Enforcement Actions
Page 3

Indemnity and
Insurance
Considerations
Page 5

Contact:

Lisa McNamara Hughes
Phone: 860-906-0103
lhughes@oakbridgeins.com
www.oakbridgeins.com

insurers' settlement contribution exhausted the D&O limits. The complication this presented is that the settlement with the individuals was only a partial settlement; several individual defendants' potential liability remains unresolved. There are no remaining D&O limits for any future settlement against the defendants who remained involved in the litigation. This startling possible combination of partial settlement and insurance exhaustion, eliminating coverage for any future settlements or judgments against the non-settling individual defendants, is one of the many considerations that should encourage Outside Directors to consider Independent Director Liability ("IDL") insurance, discussed further below.

The feature of the *Enron* and *WorldCom* settlements that has attracted the most attention is the prohibition of settling defendants from seeking reimbursement for the amount of their individual contributions. This feature is best understood in light of the plaintiffs' motivations in those cases. The institutional lead plaintiff in the *WorldCom* litigation was particularly aggressive in pursuing the individual directors; and, following the settlement, delivered a message that other well-intentioned directors can only regard with alarm:

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.²

In the months since the *WorldCom* settlement was first announced, there has been active speculation that its harshness may be attributable to the enormity of *WorldCom* shareholders' loss (the company's collapse represents the largest bankruptcy ever), the atrociousness of the fraud, and the widespread publicity surrounding the case in the midst of a series of corporate scandals.³

Nevertheless, the *WorldCom* settlement cannot be ignored as an "outlier" or unique situation. Even the remote possibility that directors may be called upon to tender their personal assets without recourse to indemnity or insurance is a sobering prospect. There has been at least one subsequent securities class action settlement, involving Tenet Healthcare, in which individual defendants (both former Tenet officers) contributed a total of \$1.5 million out of their own assets toward the settlement. The individuals were precluded from seeking insurance or indemnity for their personal contributions to the settlement.

The directors' out-of-pocket payments - \$24.75 million in the case of WorldCom and \$13 million with Enron - are extraordinary.

The feature of the Enron and WorldCom settlements that has attracted the most attention is the prohibition of settling defendants from seeking reimbursement for the amount of their individual contributions.

The SEC's Changing Enforcement Approach

The plaintiffs' class action lawyers are not the only ones showing a new aggressiveness toward Outside Directors. The SEC, in the wake of corporate scandals and the enactment of the Sarbanes-Oxley Act, has also shown an increased interest in pursuing Outside Directors. The new approach was signaled in a September 2004 speech by the SEC enforcement director, in which he said that "we intend to... focus closely in our investigations on whether Outside Directors have lived up to their role as guardians of the shareholders they serve." More recently, the SEC enforcement director explained the justification for this hostility toward Outside Directors:

*There's nothing more important from our perspective in what we do than trying to hold individuals accountable. We think it's important to punish both individual and corporate wrongdoers. Effective deterrence requires personal accountability.*⁴

The SEC's new attitude toward Outside Directors was evidenced in its June 2006 service of "Wells" notices upon three Outside Directors of Mercury Interactive in connection with the SEC's investigation of allegedly improper options grant practices at the company. (A "Wells" notice gives recipients the opportunity to explain alleged improprieties to try to convince regulators that further prosecution is unwarranted.)

The service of Wells notices on the three Mercury Interactive Outside Directors followed the December 2005 service of Wells notices on three Outside Directors of the Hollinger Corporation. The three Hollinger directors receiving notices included a former governor of Illinois, a former Ambassador to Germany, and the wife of financier Henry Kravis. The notice advised the individuals, all three of whom served on Hollinger's audit committee, that they might be sued for failing to detect allegedly improper payments that Conrad Black, Hollinger's former chairman, allegedly paid himself and certain of his associates. (The company's own internal investigation characterized Black's actions as "looting.")

The implications are stark – Outside Directors can and (if the SEC has anything to say about it) will be held accountable for the excesses and shortcomings of management.

The SEC also has recently shown its own propensity for requiring, as a condition of settling claims against individuals, that the settling parties agree not to seek indemnity or insurance. For example, in the May 2004 settlement of a civil enforcement action against Lucent Technologies and several of its former

officers and directors, the SEC required three settling individual defendants not to seek or accept indemnity or reimbursement from any source. The SEC's settlements with the infamous securities analysts from the dotcom era, Jack Grubman and Henry Blodgett, also had this same condition.

The SEC also has recently ... require[ed], as a condition of settling claims against individuals, that the settling parties agree not to seek indemnity or insurance.

Because fines and penalties typically are excluded from coverage under most D&O policies, the SEC's preclusion from seeking insurance reimbursement may seem a meaningless consideration. But costs incurred in defending against a claim seeking fines and penalties often may be covered under a D&O policy. In addition, some regulatory settlements are structured not as fines or penalties, but as compensatory damages to a common fund to be distributed to injured parties. Both the defense cost protection and the compensatory damage settlement might be subject to the regulatory reimbursement bar.⁵

Practical Considerations

Individuals who choose to serve on boards in the current environment will want to know how best to proceed in order to minimize their exposure and to shield their personal assets. In many ways, the situation remains unchanged since the scandals broke; corporations and their officers and directors can and should take steps to reduce their risk profile even – or rather, especially -- in this era of heightened corporate governance concern. While no board processes should be altered without consultation with legal counsel, there are a number of practical steps for boards to consider as part of a prudent approach to board functioning in the current environment:

Diligence: Devote the time necessary to fulfill director duties. Be diligent, ask questions, request information and attend meetings.

Understand Financial Metrics and Reporting Systems: Understand the company's business model and key financial metrics. Evaluate the system of reporting information up the chain of command. Assure the existence of adequate monitoring systems for receiving and reporting corporate information.

Compliance: Work with management quickly and efficiently to address material compliance issues, internal control deficiencies and other red flags. Most public companies are already focused on their internal controls and polices as a result of Section 404 of the Sarbanes-Oxley Act. The internal control review provides an opportunity for companies to implement best practices in areas such as revenue recognition, the role of the audit committee, insider trading policies and document retention.

Conflicts of Interest: Avoid engaging in, or fully disclose, related transactions or conflicts of interest. Be alert to the possibilities of conflicts of interest or self-dealing within the board or by management.

Risk Disclosure: As part of the company's internal control review, assure that the company's disclosure practices serve to minimize the potential exposures to securities fraud claims. In particular, the company's statements should invoke the protections of the safe harbor provisions in the Private Securities Litigation Reform Act of 1995.

Insider Trading: Make certain that the company has a compliance officer to monitor insider trading and establish trading windows and blackouts. Directors and officers who know they intend to trade in their shares of company stock in the future should consider establishing planned trading programs pursuant to SEC Rule 10b5-1.

Indemnity and Insurance Considerations

Even though the individuals in the *Enron* and *WorldCom* cases were prohibited from seeking indemnity or insurance for their settlement contributions, insurance and indemnity remain critical considerations in the vast majority of actions against corporate boards. Indeed, a recently scholarly analysis of Outside Director liability exposures concluded that the possibility that Outside Directors might be called upon to contribute to settlements out of their own funds, “would be avoided with appropriate [D&O] policy limits and current state of the art protections.”⁶ Moreover, the insurance exhaustion issue presented in the *Enron* case strongly militates in favor of a creative and thoughtful approach to the insurance equation.

Lawsuits that challenge a board’s compliance with corporate governance standards can be protracted and expensive. Outside Directors should confirm that the bylaws or charters of the boards on which they serve provide for mandatory advancement of legal expenses (subject to an unsecured undertaking to repay if a court later concludes the indemnification was unwarranted). In addition, directors will want to ensure that the company’s indemnification provisions require indemnification “to the fullest extent authorized by law.”

Companies and their boards should also review the amount and terms of their D&O coverage to assure that they have state of the art coverage and appropriate limits. There are a variety of additional insurance considerations that should be explored. These issues may be particularly important to directors with a high net worth. In addition to traditional D&O protection, directors also will want to consider the following additional coverages:

Outside Directors should confirm that the bylaws or charters of the boards on which they serve provide for mandatory advancement of legal expenses.

Excess Side A Coverage: An Excess Side A policy can provide an additional layer of protection solely for the individual directors and officers and generally follows the traditional D&O policy’s terms. This coverage is available exclusively for the individuals’ protection, and so cannot be depleted by the company’s direct liability. Coverage under an Excess Side A policy is triggered only when the company is unable to indemnify and the underlying conventional D&O insurance has been depleted by claim payments.

Side A/DIC Protection: Excess Side A coverage with “Difference in Condition” or “DIC” protection can provide additional security to guard against gaps in coverage when indemnity and corporate reimbursement coverage are unavailable. Excess Side-A/DIC insurance, if properly structured, can, among other things provide “drop down” coverage to provide immediate defense and indemnity protection under the following circumstances:

- to pay the retention under the primary traditional D&O policy if the company wrongfully withholds indemnification;
- if the traditional D&O carriers wrongfully deny coverage or deny coverage on the basis of policy exclusions that do not appear in the Side-A/DIC policy. (There are a wide variety of Side A/DIC policies available in the insurance marketplace and the broadest forms contain fewer exclusions than are standard in most traditional D&O coverage forms, such as, the ERISA and pollution exclusions);
- if the traditional D&O carriers rescind their coverage, or deny coverage, based on misrepresentations or omissions in the application for insurance;
- in the event of the insolvency of a traditional D&O carrier;
- in the event of bankruptcy, the policy would drop down and provide coverage if the traditional policy were subject to an automatic stay by a bankruptcy court.

Individual Director Liability (IDL) insurance: IDL insurance is a type of D&O protection that is limited to a specified individual or group of individuals and is available to provide coverage in the event that indemnity or insurance is unavailable for those individuals from other sources. It is important to note that because the IDL policy's limits are dedicated to the specified individuals, the limits are not subject to exhaustion by the settlement or defense of another person or entity. Some IDL policies also include "drop down" protection in the event that the traditional D&O carriers' policies are unavailable due to insurer insolvency, rescission, or a stay imposed by a bankruptcy court.

Conclusion

In this environment, being an informed buyer of D&O insurance is critical. Companies and their boards will want to review their D&O insurance program with knowledgeable experts to ensure that their coverage provides the best available protection. As the discussion above shows, the current environment requires boards to consider a broad array of liability exposures and insurance possibilities, and so it is more important than ever that they work with insurance professionals who understand all of the alternatives and how to structure an insurance program that best meets their needs.

Footnotes

¹ U.S. Chamber of Commerce Institute for Legal Reform, "Securities Class Action Litigations: How is the System Working Ten Years After Enactment of the Private Securities Litigation Reform Act" (Feb. 2006).

² New York State Comptroller News Release, "Hevesi Announces Historic Settlement, Former WorldCom Directors to Pay From Own Pockets" (Jan. 7, 2005).

³ A particularly thoughtful discussion of the extent of Outside Director liability in the wake of the Enron and World Com settlements may be found in the following article: M. Klausner, "The Risk of Liability for Outside Directors," *PLUS Journal* (June 2006).

⁴ "Your Fault: Directors' Payback Deal Shows Corporate Boards Aren't Safe," *Wall Street Journal*, Jan. 7, 2005.

⁵ D. Bailey, "D&O Liability: Now It's Personal," Bailey Cavalieri, http://www.baileycavalieri.com/CM/Articles/BAILEY_COLUMBUS.pdf. (accessed May 22, 2006).

⁶ See Klausner, *op. cit.*, at page 2.

About the Author

This article was prepared by Kevin M. LaCroix, Esq. of OakBridge Insurance Services. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 25 years. Prior to joining OakBridge, Kevin was President of Genesis Professional Liability Managers, a D&O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell. Kevin is based in OakBridge's Beachwood, Ohio office. Kevin's direct dial phone number is (216) 378-7817, and his email address is klacroix@oakbridgeins.com.

About OakBridge Insurance Services

OakBridge Insurance Services is one of the nation's leading Executive Liability insurance intermediaries. The firm provides its services through CoBrokerage alliances with strong, regional insurance brokers across the country. Please inquire whether your broker works with OakBridge or visit www.oakbridgeins.com.

Disclaimer

This article is provided for informational purposes only and is not intended to provide legal advice. The issues and suggestions presented in this article should be reviewed with outside counsel. Any change in board processes or practices should be discussed with outside counsel before implementation.