

## Enron's Legacies and D&O Risk

Shortly after former Enron CEO Jeffrey Skilling's October 23, 2006 sentencing, the Enron Task Force announced that it was closing down - declaring that its mission was largely complete. The media treated these events as endpoints in the Enron criminal scandal; for example, the *Washington Post* ran an article entitled "End of Enron's Saga Brings Era to a Close."<sup>1</sup> Whether or not these events really do represent the end of an era, it may now be time to take a look at the Enron scandal and to assess its lasting impact.

*Now that the key figures in the Enron scandal have all had their day in court, what are Enron's legacies? What does it all mean for D&O risk?*

This article examines several questions: Have we reached the end of an era of high profile criminal prosecutions? And now that the key figures in the Enron scandal have all had their day in court, what are Enron's legacies? Finally, what does it all mean for D&O risk?

### The End of an Era?

While Skilling's sentencing was highly anticipated and had all the air of a culminating event, a fresh wave of scandals suggests that white collar criminal prosecutions will remain an important part of the legal landscape for the foreseeable future. Indeed, the same week as Skilling's sentencing, Converse Technology's former CFO became the first corporate official to plead guilty to criminal charges in connection with the options backdating scandal. During the same week, Refco's former CFO was indicted for accounting allegations raised following the company's ill-fated IPO. These are just the latest signs that white collar crime prosecutions will remain a prosecutorial high priority for the foreseeable future.

And though Skilling's sentencing may represent a high water mark of sorts, it is far from the end of the Enron saga itself. There are still a number of Enron-related prosecutions in the pipeline. For example, three British bankers, extradited to the U.S. earlier this year, will stand trial in early 2007 on allegations that they stole from their former employer in connection with an Enron-related transaction. There may be new trials for several former Enron executives whose earlier proceedings ended in mistrials. Several key Enron defendants are yet to be sentenced. The civil lawsuit against Enron's investment banks (at least the ones that have not yet settled) remains

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pending. And even when the book is finally closed on Enron, whenever that may be, the assault on corporate fraud seems likely to continue. This forward-looking thought leads to the next question: Now that the Enron Task Force has disbanded, what are Enron's legacies?

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## Enron's Legacies

The word "Enron" has moved into the language, both as a reference to the company itself and the scandals that followed its demise, as well as a shorthand expression for all of the corporate scandals that were uncovered earlier in this decade. While these two senses of the word are distinct, the two meanings merge when looking at Enron's legacies. This is because Enron's impact has been specific (for example, in connection with the criminal prosecution of former Enron officials), and general (in connection with the larger impact on markets, legislation, and corporate culture). To follow are a few of its legacies when using "Enron" in both of these senses:

**1. New Corporate Governance Culture:** Without question, the most important of Enron's legacies is the new culture of corporate governance. In Enron's wake, no corporation can avoid the implementation of serious internal compliance systems to detect and deter corruption. By the same token, the role and functioning of corporate boards has also been dramatically altered. Boards are now more active, independent and involved, and in many important ways providing meaningful oversight of corporate management. Just one aspect of the way boards have changed is the increased emphasis on independent board composition. According to the National Association of Corporate Directors, 83% of boards now say that more than half of their directors are independent, up from only 54% in 2000.

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These changes hold out the intriguing possibility that improved corporate governance will result in reduced D&O risk. Indeed, some commentators believe that improved governance explains the reduced number of securities fraud lawsuits that have been filed so far in 2006. For example, Stanford Law Professor Joseph Grundfest has stated that "extensive and expensive corporate efforts to improve governance and accounting have reduced plaintiffs' ability to allege fraud."<sup>2</sup> There is no question that the governance reforms have improved corporate officials' sensitivity to potential wrongdoing. But even allowing for this heightened vigilance, other commentators remain skeptical that governance reforms alone can explain the reduced number of

lawsuits. As D&O authority and prominent coverage attorney Dan Bailey has written with respect to the impact of corporate governance reform on the number of securities lawsuits, “it appears unlikely that this is a major contributing factor to the reduced filings.”<sup>3</sup>

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In fact, increased board independence and oversight has also in some cases led to boardroom turmoil that in turn has resulted in claims against, between and among directors and officers. The unfortunate and highly publicized events involving H-P’s Board are but the most prominent example of this effect.

And so, while improved corporate governance is an unquestionably important part of Enron’s legacy, the positive significance of that legacy in terms of D & O risk still remains uncertain. In addition, as discussed further below, there are movements afoot that could potentially alter this legacy.

**2. Whistleblower Protection:** The new culture of oversight is not limited to just the boardroom. Serious internal compliance programs, combined with the provisions of the Sarbanes-Oxley Act providing corporate whistleblower protection, encourage employees to speak up and report conduct they believe may have crossed the line. (The Sarbanes-Oxley whistleblower provision is of course a legislative tribute to Enron’s own whistleblower, Sherron Watkins.)

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The existence of the whistleblower provisions potentially could translate to increased D&O risk of claims based on the whistleblower’s disclosures. Thus far, the few whistleblower cases to emerge have gotten bogged down in procedural delays of a kind that could well deter future whistleblowers.<sup>4</sup> Certainly there have been no dramatic cases where a whistleblower’s surprising revelations have resulted in significant claims against corporate officials.

**3. CEOs in the hot seat:** With all of the improved corporate governance procedures has also come increased scrutiny of senior corporate management. There is no doubt that following Enron and the other corporate scandals that CEOs’ abilities to hold onto their jobs is becoming more precarious. Since early 2005, the boards of some of the country’s largest companies have ousted their CEOs – including Bristol-Myers

Squibb, Fannie Mae, Pfizer, Merck, and American International Group. In addition, executive compensation has come under intense scrutiny. More active boards and a greater willingness to challenge management, as well as a changed regulatory environment, have all contributed to this effect. Significant turnover at the most senior levels of management creates a volatile environment in which accusations of wrongdoing may more easily arise. Recurring questions about executive compensation merely add to this atmosphere of increased tension. The recent wave of lawsuits involving options backdating allegations illustrates how quickly questions about compensation and management performance can lead both to executive departures and to D&O claims. The increased scrutiny under which top management now operate is an important source of heightened D&O risk.

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**4. White Collar Crime Enforcement:** One of Enron’s most durable legacies is the creation of a prosecutorial “police force” to identify and punish corporate crime. Even though the Enron Task Force has disbanded, the Corporate Fraud Task Force remains in existence and continues to find activities to investigate and prosecute. This picture of a permanent white collar fraud police force was vividly illustrated in the recent remarks of Timothy J. Coleman, a former U.S. Justice Department official who was responsible for the Corporate Fraud Task Force and who supervised the Enron Task Force and the Criminal Fraud Section. An October 25, 2006 *Washington Post* article attributed to Coleman the statement that:

The legions of investigators hired by securities regulators, federal prosecutors and the FBI will pay lasting dividends because they will become a “standing army” ready to target business wrongdoing. “Whether it’s stock options, mutual funds or something else, corporate America should expect a continuing series of major, nationwide investigations for the foreseeable future,” Coleman said.<sup>5</sup>

A “standing army” to prosecute crime will inevitably find offenses to investigate, prosecute, and punish, and so the likelihood of a series of future major corporate crime investigations is one of Enron’s most tangible legacies.

*The threat of future claims arising from corporate criminal investigations is perhaps the most important way that Enron has affected D&O risk.*

With the increased prospect of prosecutorial scrutiny comes the increased possibility of D&O claims. Just as all of the major corporate criminal scandals involved parallel civil litigation, and just as the options backdating investigations have also meant a new wave of shareholder lawsuits, so too the criminal investigations yet to come will also lead to civil

claims against directors and officers. The threat of future claims arising from corporate criminal investigations is perhaps the most important way that Enron has affected D&O risk.

*D&O insurers and their policyholders face a changed claims environment characterized by increased risk and heightened severity expectations.*

**5. Increased Severity of Civil Securities Fraud Lawsuits:** Enron and the other corporate scandals have also changed the environment for civil securities fraud lawsuits. These changes have important implications for D&O carriers and their insureds. Specifically, average settlements in securities fraud lawsuits have escalated enormously due to the civil cases arising out of corporate scandals. It may be that the egregiousness of these cases drove an increase in average severity that will diminish once the worst cases have played through the system. But while the average settlements may diminish somewhat after the worst cases are gone, the rough idea of “what cases like this settle for” has been ratcheted upwards in a way that is unlikely to completely go away. This heightened severity standard has important implications for D&O carriers’ average expected severity (particularly for excess carriers) as well as for D&O insurance buyers’ limits selection. Both carriers and policyholders must now be prepared for much more expensive outcomes.

### How Permanent Are Enron’s Legacies?

Shortly before the Enron Task Force disbanded, another group, the Committee on Capital Markets Regulation, formed to take a look at the effect of regulatory burdens on the competitiveness of the U.S securities markets in the global economy. (The Committee has become known as the Paulson Committee because of the public support that Treasury Secretary Henry Paulson has given the Committee.) The Committee consists of leading figures from academia and business, and includes prominent figures from the current Bush administration. The Committee is looking at regulatory reforms that might improve U.S. competitiveness.

Among other things, the Paulson Committee is reviewing whether Sarbanes-Oxley represented an overreaction, and whether there are revisions that might swing the regulatory pendulum back to the middle. The Committee’s work has been accompanied by public statements from President Bush and Vice President Cheney that perhaps Sarbanes-Oxley went too far. The Paulson Committee released its

Interim Report on November 30, 2006. (The Committee will continue to explore regulatory reform issues and will release a second report early next year.) The Interim Report contained a wide variety of suggested regulatory and legislative reforms, including suggested revisions to the Sarbanes-Oxley Act's provisions in Section 404 regarding internal controls.

The Interim Report's release is merely the opening salvo in what will likely be a prolonged exchange of views and proposals on the subject of regulatory reform. Among other things, the U.S. Chamber of Commerce is expected to release its own report early next year. In addition, Sen. Charles Schumer and New York Mayor Michael Bloomberg have hired the management consulting firm McKinsey & Co. to assess market competitiveness and its impact on New York City's economy. The Treasury Department is hosting a conference early next year to discuss the state of the country's regulatory, legal and accounting environment. What changes may emerge from these efforts remains to be seen, but the regulatory reforms that could follow could potentially affect the permanency of some of Enron's most significant legacies.

### Conclusion

There may yet be more of the Enron story to be told, and the current scandals (such as the options backdating investigations) undoubtedly will have an impact on corporate culture. The work of the Paulson Committee and other reform efforts may also affect the post-Enron regulatory environment. But even though the picture may continue to evolve, that does not diminish the enormous, categorical changes that Enron has wrought. Principles and practices of corporate governance are changed forever. Corporate compliance programs are now an important part of every company's internal operations. White collar fraud prosecution is empowered and an important component of the contemporary legal landscape. And D & O insurers and their policyholders face a changed claims environment characterized by increased risk and heightened severity expectations. By any measure, Enron's demise was a milestone event in the history of American corporate culture, and its ramifications will affect companies for years and decades to come.

<sup>1</sup> C. Johnson, "End of Enron's Saga Brings Era to a Close," *Washington Post*, <http://www.washingtonpost.com/wp-dyn/content/article/2006/10/24/AR2006102401246.html> (Oct. 25, 2006).

<sup>2</sup> News Release, "Stanford Law School and Cornerstone Research Release Mid-Year Securities Fraud Class Action Filings Report," [http://securities.stanford.edu/scac\\_press/MYIR2006Release.pdf](http://securities.stanford.edu/scac_press/MYIR2006Release.pdf) (July 26, 2006).

<sup>3</sup> D. Bailey, "Why Are There Fewer Securities Suits?" <http://www.baileycavalieri.com/CM/Articles/Why-Are-There-Fewer-Securities-Suits.asp> (Accessed Oct. 29, 2006).

<sup>4</sup> See K. LaCroix, "Sox Whistleblower Protection: More Theoretical Than Real?" *The D&O Diary*, <http://dandodiary.blogspot.com/2006/10/sox-whistleblower-protection-more.html> (Oct. 7, 2006).

<sup>5</sup> See C. Johnson, *op. cit.*

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You access the weblog via our website at [www.oakbridgeins.com](http://www.oakbridgeins.com). To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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