Financial Services and E-Commerce

The WorldCom and Enron Settlements: Politics Rears its Ugly Head

*By Peter J. Wallison**

The recent settlements of lawsuits against WorldCom and Enron involved something entirely new in securities litigation—the introduction of political considerations into the process of settling class actions. In both cases, public officials acting as lead plaintiffs refused to settle unless the outside directors of the companies made payments out of their own pockets, and the officials were widely praised in the media for doing so. This development will increase the likelihood that similar concessions will be demanded of settling directors in the future and will make the recruitment of directors for the boards of public companies considerably more difficult. That result cuts against the policy of the Sarbanes-Oxley Act—which was intended to place more responsibility on the independent directors of public companies—and suggests that a revision of the liabilities of directors under the federal securities laws, in cases of management fraud, may be appropriate.

Recent news that the independent directors of WorldCom and Enron had agreed to settle outstanding securities class action suits with payments from their personal assets should be getting more attention than it has. Although the WorldCom settlement was rejected by the court for technical reasons, it established a precedent that is likely to bedevil corporate governance well into the future.

At the most fundamental level, these settlements raise questions about the scope of directors' liabilities under the securities laws, and may also challenge a principal objective of the Sarbanes-Oxley Act, which was intended to place more control over such things as financial disclosure by public companies in the hands of independent directors. But the most troublesome aspect of the settlements was the involvement of political officials and political objectives—a new factor that considerably enlarges the risk that individuals must weigh when they consider whether to become or remain as directors of public companies.

In the WorldCom settlement, ten directors agreed to pay an aggregate of $18 million to settle their liability to WorldCom bondholders. Similarly, ten Enron directors agreed to a settlement of $13 million. At the insistence of the lead plaintiffs in both cases, the directors' payments were not to be reimbursed by insurance or by the companies involved. The collapse of both WorldCom and Enron was the result in both cases of management's falsification of the company's financial statements, and in both cases it was determined by the court that the directors had not participated in the misrepresentations involved; they had simply failed to detect it. Thus, the directors involved were required to make payments out of their personal assets for failing to detect a fraud, even though a fraud—by definition—is designed to escape detection.

Directors' Liability

The Enron and WorldCom class actions both arose under the securities laws, since both companies had sold securities using registration statements filed with the Securities and Exchange Commission that contained false financial statements. Under the securities laws, a director who signs a registration statement that contains materially false information is liable to any purchaser of those securities—no intent to deceive is required—but may establish a defense of due diligence: that he or she made a good faith effort to ascertain that the information in the registration was correct.

This is a tougher standard than is generally required of directors under ordinary corporate law, which is based on state standards derived from the common law. There, directors are deemed to have a "duty of care," which is defined in the model corporate law developed by the American Law Institute as "the care that a person in a like position would reasonably believe appropriate under similar circumstances." A special committee of the American Bar Association has developed a handbook for directors that further elucidates this standard, noting that in exercising his or her responsibilities:

> ...a director is entitled to rely on management and on board committees on which the director does not serve to perform their delegated responsibilities. A director is entitled to rely on reports, opinions, information and statements, including financial statements and other financial data, presented by . . . the corporation's officers or employees whom the director reasonably believes to be reliable and competent in the matters presented [and] . . . legal counsel, public accountants or other persons as to matters that the director reasonably believes to be within the person's professional or expert competence or as to which the person merits confidence.[1]

Thus, in acting under ordinary corporate law, directors can rely on management and accountants whom they reasonably believe to be reliable, and shareholders and others who complain about directors' actions must prove that they acted in violation of their duty of care. But under the securities laws directors are liable for material misstatements in a registration statement unless they can carry the burden of establishing their own diligence in determining whether the facts were correct.

Under the egregious facts of both the WorldCom and Enron cases, it is certainly possible to argue—in hindsight—that the directors should have asked more questions or not relied on the statements of management, or the companies' accountants or counsel. But it is important to note that both Enron and WorldCom were cases of fraud, where management took affirmative steps to withhold the truth from the directors; the settlements demonstrate that directors can be held responsible for failing to discover that management was lying. Given the difficulty, in general, of determining another person's honesty and trustworthiness—certainly before becoming a director, and even afterward—there can be no denying that these settlements signal increased risks for directors, at least in cases where securities law liabilities are involved.

This in itself would be a reason for Congress to revisit the question of director liability under the securities laws. Currently, the law makes no distinction between cases where management has committed deliberate fraud—having taken affirmative steps to hide the facts—and cases where registration statements merely contain material misstatements that could have been discovered with diligence.

There is good reason for the securities laws to make this distinction. The failure of a director to detect a material misrepresentation or omission could be negligence, which by definition is a violation of a duty of care and strong evidence of the absence of due diligence. The lack of attention to detail that gave rise to this failure is at least within the control of the director. But that is not true of a failure to detect a fraud. Since those who commit fraud are engaged not only in misrepresentation of facts but in taking affirmative action to prevent the discovery of the truth, as a matter of simple justice it seems unreasonable to hold directors responsible for discovering something that has been deliberately withheld from them. The same principle would appear to be applicable to underwriters, who have the same liabilities under the same circumstances as directors. It seems unreasonable to hold them responsible for failing to discover facts that management has taken steps to hide.

Thus, it seems sensible that whenever the courts have found that management has perpetrated a fraud, the company's independent or outside directors and underwriters should not be held responsible for failing to discover management's deception. Of course, there can be cases where the directors or underwriters have been so lax that an obvious fraud escaped their notice. But in these cases securities law should require the complaining party to demonstrate the director's gross negligence, instead of placing on the directors and underwriters the burden of establishing a due diligence defense.

As a matter of policy, too, it also seems sensible to reduce the potential liabilities of directors where the courts have found evidence of management fraud. The Sarbanes-Oxley Act assumes that it will be possible to recruit independent directors to serve on corporate boards. This has already turned out to be more difficult than initially anticipated. Discussion at an AEI conference in May 2004[2] confirmed reports from corporate recruiters that the field of desirable directors had narrowed considerably after Sarbanes-Oxley, principally because of the extra time now required of directors in meeting the act's requirements, concern about additional liability, and the reluctance of CEOs to serve on nonaffiliated boards. Now, the settlements in the WorldCom and Enron cases—which seem to put the personal assets of directors at risk—can only make it even more difficult to recruit qualified independent directors to serve on the boards of public companies.

Politics Enters the Picture

Complicating this question, moreover, is the fact that the settlements in these two cases contain one element that is entirely different from anything seen before—the sudden introduction of political considerations in the settlement process. In both cases the lead plaintiffs were public organizations—the New York state employees' pension fund in the case of WorldCom and the California university system in Enron. The New York fund is headed by the state comptroller, Alan G. Hevesi, an elected official with the usual motives for seeking publicity as a way of advancing to higher office.

According to Comptroller Hevesi's own statements, he refused to settle with the WorldCom directors unless they made substantial payments out of their own pockets: "I felt personally," he told the *Washington Post* for a January 8 article, "that this would be unfair and not a deterrent for future failure on the part of the directors if they were not held personally responsible." Thus, Comptroller Hevesi's personal views about how to discipline directors—not the question of what would be best for the pension fund he heads—was the determining factor in proceeding with the settlement. Eventually, the settlement required the directors to pay 20 percent of their net worth, exclusive of the value of their personal residences.

This is something seemingly without precedent. Previously, a decision whether to settle with one or more defendants was made on the basis of whether additional litigation would produce a larger award. The strength of the case was balanced against the costs of further litigation. In this case, however, the lead plaintiff was seeking a political goal, a factor that will undoubtedly make directors and prospective directors far more wary of serving on boards than they have been in the past. Under the Hevesi Rule, they will be specially singled out for punishment, because that will presumably make other directors more diligent.

The settlement arrangements were widely reported in the press, with Comptroller Hevesi lionized for his position. This, for example, from Gretchen Morgenson in the *New York Times* (January 9, 2005):

> Hats off to Alan G. Hevesi, comptroller of New York State and trustee of its Common Retirement Fund, who has proved that, yes, shareholders can hold individuals responsible for wrongdoing at companies. Institutional shareholders can no longer hide behind lame excuses for not following Mr. Hevesi's lead and demanding that the right people pay for malfeasance.

It is not hard to imagine that with declarations like this in the media there will be no shortage in the future of political officials, heading up public pension funds or in other capacities, who are looking for opportunities to make directors pay out of pocket for alleged malfeasance in supervising corporate managements. This has been made to sound like good policy, and—considering the media image of directors as the wealthy, underworked beneficiaries of corporate largesse—it will certainly be good politics. If politically motivated settlement demands of this kind are to be the wave of the future, it is difficult to understand why anyone would serve on the board of a public company. As difficult as it has been to find corporate directors since the advent of Sarbanes-Oxley, it will now be more difficult still.

Too Unusual to Set Precedent?

One important question is whether the WorldCom and Enron cases are so unusual that their settlements are *sui generis* and should not be seen as precedents for the future. They were both huge frauds, resulting in bankruptcy when discovered. The fact that the companies were both bankrupt was one reason the directors felt compelled to settle, since they could no longer be indemnified by the companies. This fact in itself is unlikely to provide much consolation to directors at other companies, since significant frauds can easily bankrupt even healthy companies. Accordingly, risk-averse directors, when considering whether to join or remain on corporate boards after the Enron and WorldCom settlements, are likely to take little comfort from provisions in a corporate charter that permit full reimbursement of directors under most foreseeable circumstances.

That leaves directors and officers' liability (D&O) insurance. All such policies have limitations on liability, which can be exceeded in large frauds such as Enron and WorldCom. In the WorldCom case, the damages demanded by the bondholders were $17 billion for the bond sales in 2000 and 2001 alone. It appears that one of the reasons the WorldCom and Enron directors agreed to settle was the likelihood that the dollar limitations in their D&O policies would be exceeded by defense costs, together with the ultimate liability that might be assessed against them at trial. Thus, although D&O coverage with high enough limits might enable directors to avoid having to dip into their personal resources, that will not always be the case—especially in large frauds involving securities offerings.

Even if the D&O coverage for WorldCom's directors had been sufficient to cover their liabilities and defense costs, it appears that a plaintiff determined to require them to pay out of their own pockets could have obtained this result. Many D&O policies allow the insurer to settle the case, with the consent of the directors. If the directors do not consent, the insurer's liability is limited to the amount of the proposed settlement, and the directors bear the risk of litigating, including the litigation costs.

What would happen if a plaintiff refused to settle with the insurer unless the directors agreed to waive all or a portion of the reimbursement they would receive from the D&O insurer? The answer is not entirely clear, but it appears that in this case the directors would be in much the same position as the WorldCom and Enron directors. If they refused to agree to the terms of the settlement, which would include their paying unreimbursable out-of-pocket costs, they would be required to take the risk of litigating.

It is important to note that this scenario is likely to occur only where the lead plaintiff has political objectives such as those of Comptroller Hevesi. In the ordinary case, the lead plaintiff would be interested solely in obtaining the maximum recovery for the plaintiff group, taking into account the probable costs and risks of litigation, and would not care whether the dollar payment came from the insurer or the pockets of the directors themselves.

WorldCom Precedent May Survive Rejection of Settlement

Finally, there is the question whether the court's refusal in the WorldCom case to approve the settlement suggests that future efforts to force directors to make out-of-pocket payments are not tenable. The Private Securities Litigation Reform Act (PSLRA), adopted in 1995, attempted to provide for the proportionate allocation of damages awarded in securities class actions in cases where outside directors were not knowing participants in a violation of the securities laws. It permitted pretrial settlements by the directors, but provided that the ultimate award, if any, after trial, would be reduced for all defendants who went to trial by *the greater of* (i) the amount actually paid in settlement by a settling director, or (ii) the amount of the total award won by the plaintiff that corresponds to the percentage of responsibility (for the loss) of a director who settled before trial. Under this procedure, the trier of fact (usually a jury) first determines the amount to be awarded to the plaintiff, and then the percentage of liability of each defendant, including those who had previously settled.

Thus, if the award were $100 million, and the settling directors had paid $1 million, the defendants who had not settled would be required to pay $99 million to the plaintiff. However, if the defendants who had previously settled were deemed responsible for 50 percent of the loss, the defendants who had not settled would be responsible for paying only 50 percent of the award to the plaintiff, or $50 million. Obviously, this provision can substantially reduce the liability of defendants who go to trial, even if they lose.

This in itself would not have prevented the settlement, were it not for a quirk in the law. The PSLRA contemplates two classes of director defendants—those who are knowing participants in the violation of the law and those who are not—and special liability provisions apply to each. Those who are found after trial not to be knowing participants can only be required to pay for their share of the total award up to their percentage of responsibility; those who are found to be knowing participants are jointly and severally liable, which means that a winning plaintiff can collect the entire judgment from a single wealthy defendant such as an underwriter, who then has a right to collect from other defendants up to their respective shares of the loss. However, the PSLRA provides that if a non-knowing director has settled before trial, the percentage of that director's responsibility must be subtracted from the total award, even though it reduces the liability of the other defendants.

To avoid this possibility, the settlement with the WorldCom directors attempted to revise that rule by capping the possible reduction of the award at the amount the settling directors were able to pay. The non-settling defendants—the underwriters—objected to this provision, because it deprived them of the full benefits that they could have obtained from the settlement. The court agreed, and threw out the settlement.

That outcome will certainly make settlements with directors before trial much more difficult, and it is certainly bad news for directors, who may not now be able to settle before trial. But it will not prevent plaintiffs who have motives similar to those of Comptroller Hevesi from requiring that directors pay a portion of any award from their own pockets. After a trial, the maximum liability of a non-knowing director defendant is that defendant's net worth, so a plaintiff appears to have the option of reducing the amount collected from any indemnifying party (such as the company itself or a D&O insurer) to something less than the directors' net worth if the directors will agree to pay a portion of the award from their personal assets.

Conclusion

Accordingly, we are left with this result: Because directors have the burden of proving their own due diligence in securities class actions, even in cases of fraud by management, the risk that they will be held liable is higher than in ordinary cases of director malfeasance—where directors are held only to a duty of care. The fact that this liability has now resulted in directors paying an award out of their own pockets will make it even more difficult than before to recruit qualified independent directors to serve on boards of directors, and is thus in conflict with the purpose and policy of the Sarbanes-Oxley Act.

This problem—already serious—has now been compounded by the introduction of political objectives into the settlement process, making it substantially more likely that directors will be required to face personal liability in securities class actions. Under these circumstances, it may be necessary for Congress—in order to fulfill the purposes of Sarbanes-Oxley to modify both the settlement provisions of the PSLRA and the scope of directors' liability under the securities laws in cases where the directors were not knowing participants in a fraud perpetrated by management.

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Footnotes

[1] American Bar Association, *Corporate Director's Guidebook* (May, 2004), available through www.lexis.com.

[2] "Sarbanes-Oxley: A Review"; conference materials are available at http://www.aei.org/event809.