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Whither Directors' Personal Liability?

By Harvey L. Pitt, Compliance Week Columnist—January 25, 2005

Over the past several years, the liability landscape for corporate directors has been changing dramatically. This process has been exacerbated by the seemingly endless string of corporate scandals, involving the implosion of some of our largest companies. Most recently, three events are causing greater focus by directors on the thorny issue of personal liability, and suggest the need for outside directors to adopt a proactive stance in performing their oversight functions: The Emerging Communications case in the Delaware Chancery Court, and the recent settlements—by directors—of WorldCom and Enron class action litigation.


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To some, these recent events confirm their pre-existing view that board service for public companies is no longer feasible or desirable. That is, I suggest, an over-reaction. Equally off the mark is the observation of others that there is—and there will be—no dearth of board candidates because directors will still enjoy traveling to pleasant foreign locations for board meetings and the clubhouse status of being a director. Instead, there are some prudent steps that directors—especially outside directors—should consider before declining to serve on a public company board, or deciding to resign from a public company board on which they presently sit.

The Emerging Communications Decision

In Emerging Communications, the Delaware Chancery Court (per Supreme Court Justice Jacobs, sitting by designation) held that a director who joined all his colleagues in approving an unfair two-step going-private transaction could not invoke the standard business judgment rule exculpating directors from liability when they rely, in good faith, on the advice of experts. The director, Salvatore Muoio, had been a securities analyst and a portfolio manager, and thus was found to possess "a specialized financial expertise …" that was "equivalent, if not superior," to the expertise of the Special Board Committee's outside financial experts. This specialized expertise, in turn, made this director liable when his colleagues were not, because he had, in the Court's view, "far less reason [than the others] to defer" to the outside expert's opinions and conclusions.

One implication of this holding, especially given Sarbanes-Oxley's requirement that audit committees of public companies contain at least one outside director with financial expertise, is that those with special expertise need to take extra care if they wish their utilization of and reliance on outside experts to invoke the business judgment rule and exculpate them from liability in shareholder litigation. Another significant implication is that those directors who lack "specialized financial expertise" may be entitled to rely upon the judgments and opinions of those who in fact do possess specialized financial expertise.

The WorldCom And Enron Class Action Settlements

Last month, plaintiffs settling the WorldCom and Enron class action litigation have demanded, and received, agreement that the outside directors of both companies would put up a significant amount of their own assets in settling those cases. Despite the existence of D&O insurance coverage, individual directors put up as much as 20 percent of their collective net worth to settle an action where the directors did not know, but also did not prevent, a securities fraud from occurring.

In the current climate confronting any defendant in securities litigation, there is clearly a risk that a jury—especially one in the city where a now-defunct company played a major economic role—will impose liability in draconian amounts. In both the WorldCom and Enron cases, the judgment made was that the risk of an adverse jury decision was far more compelling than the burden of employing some personal assets to purchase a settlement of the litigation.

What's A Director (Or Would-Be Director) To Do?

Rather than assuming board service is now fatally fraught with peril, there are some proactive steps that directors, and would-be directors, can consider to minimize the likelihood of liability, especially personal liability.

1. **Due diligence.** The days when a mere invitation to join a board was considered an honor not lightly to be refused are long gone. Board service may not be "an honor," but it is a serious undertaking. Prior to accepting an invitation to join a board, candidates need to do a thorough job of due diligence, examining the company's operations, the working relationships between management and the board, the assets provided to the board, and the company's adherence to good governance and full transparency. Prospective board candidates should not rely solely on their own due diligence, but should be given the tools to have an independent evaluation made of the company's transparency and governance.
2. **Understand the company.** Corporations are complex entities, and they often cover very wide swaths. Directors need to understand the nature of the company's business, its culture, its patterns, its industry, and the problems that face both the specific company as well as other companies in similar lines of business.
3. **Know the management team.** Who are the corporate managers? What are their strengths, their weaknesses? What access does a director, or prospective director, have to anyone working at, or for, the company?
4. **Know the strengths and weaknesses of the other directors.** Who are the other directors? What expertise, if any, do they possess? How do they approach their jobs? Being the most knowledgeable, or the hardest-working, director on a board is a negative, not a positive. The best boards will balance the talents of many individuals who bring unique insights, expertise and perspectives to the boardroom, upon whom the other directors can all rely.
5. **Ensure the existence and availability of a team of outside experts.** The Sarbanes-Oxley Act of 2002 requires companies to make resources available to directors to perform their myriad responsibilities. In light of the Emerging Communications decision, the directors should be satisfied that their outside experts have far greater financial and

other expertise than the members of the board. The outside directors should select their own outside experts.

6. **Have a game plan.** The outside directors need to be organized, with an active agenda for each fiscal year, and with established experts on hand—and on call—to assist the directors. How many times will the board and critical committees—the audit, compensation, nominating, legal compliance, and disclosure committees—meet? When will substantive issues and risks be examined by the board and these committees? Advance planning, and time for thoughtful evaluation, are crucial.
7. **Require full disclosure.** An effective board is one in which management and the outside directors work collaboratively to achieve the company's desired objectives. A critical element of such a working relationship is full disclosure. While directors cannot immerse themselves in the intricacies of a company's many-faceted operations, they can ensure that all critical information is given to them on a timely basis.
8. **Assure the integrity of the decision-making process.** Board members need to understand, and be satisfied with, the types of decisions they will be asked to make, and those that will be entrusted to management's discretion. Board packages that either "dumb down" important issues, or create a "sea of impenetrable documents," disserve the company, its managers, and the directors. It is critical for directors to make certain that they are given every important detail regarding any proposed action.
9. **Is there a continuous stream of information flowing to the board?** In years past, some managers had the tendency either to wait until there was no alternative to bring the board "into the loop," or to distrust the ability of the board to maintain confidentiality of sensitive information. Board members should have a continuous flow of relevant and significant data. If management thinks some directors may leak sensitive data, those directors should be replaced. The solution can never be to withhold information from the board.
10. **Actively play-out crisis scenarios.** Every day, the business press reports another terrible disaster at an otherwise fine company. Many of these can be handled far more deftly than they actually are, but the lack of crisis preparation impairs the ability of companies to perform well in the face of a crisis.
11. **Look for problems before they find you.** The ancient wisdom of not looking for problems that haven't surfaced is no longer possible or wise. Boards need to understand what risks a company may implicitly be accepting in the way it does business, and need to be certain that there is a determined effort to ascertain whether problems are lurking just beneath the surface.
12. **Regularly evaluate the company's systems, procedures and approaches.** The board needs to be proactive in understanding what systems, procedures, assumptions and approaches management is employing to keep the company on track.
13. **Keep accurate and complete records of all board deliberations.** As I've noted in prior Compliance Week columns, it's important not only to do the right thing, but to be able to demonstrate that you've done the right thing. This places a premium on good recordkeeping.
14. **Avoid two-dimensional disclosure and assessment efforts.** One of the biggest mistakes a company can make is to ignore comparative approaches at similarly-situated companies. Particularly in disclosure contexts, it's essential that the company's proposed disclosures are compared with its core group of peer companies.

15. **Consider the advantages of a forensic audit.** Most companies would benefit if their audit committees sought to have the company undergo a forensic audit on a triennial time frame.
16. **Educate, sensitize, evaluate.** The ability to function effectively is not an inherent skill—it is a learned talent. Companies need to make sure that directors, officers, employees and others are educated periodically about critical issues, sensitized to new standards and requirements, and evaluated on their performance.
17. **Obtain comprehensive D&O/E&O insurance coverage.** In addition to broad rights of indemnification under corporate charters, comprehensive insurance coverage is essential because directors may incur personal liability, the company may be insolvent, or state or federal law may limit indemnification or advancement of expenses. Outside directors should be satisfied that the disqualification of one or more directors will not disqualify the remaining directors. Outside directors also should look into excess "Side A" coverage, which protects innocent outside directors when the company's standard policies are rescinded or do not fully protect the outside directors.
18. **Keep apprised of changing policies regarding personal liability.** The only certain thing about the current landscape regarding personal liability is its uncertainty. We are witnessing evolving standards, sometimes affected not just by substance but by policy and even political concerns. A well-informed director is a smart director; making certain that you know the changing landscape of liability is the surest way to find critical paths to avoiding that liability.
19. **Require periodic board effectiveness assessments.** Unfortunately, it isn't enough to be dedicated and proactive. Directors need the comfort of knowing that they are performing the way shareholders reasonably have a right to expect them to perform. This is best done through periodic evaluations by independent outside experts, who can improve the board's performance based on its actual approach to issues.

While recent events understandably give rise to concerns about the new potential for increased personal liability, directors who approach their responsibilities with care and common sense, and who are constructively proactive, should find themselves in a positive situation vis-à-vis personal liability.

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