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The Perils of Outside Directors: How to Avoid Personal Liability in the Post-Enron Era

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In decisions that sent shockwaves throughout the boardrooms of corporate America, outside directors of WorldCom* and Enron recently agreed to settlements requiring these directors to make payments to plaintiffs from the directors' personal assets. Until these unusual settlements, outside directors rarely, if ever, agreed to contribute personally to settlements of securities litigation – and plaintiffs rarely, if ever, realistically sought such contributions. In the wake of such surprising results, greater scrutiny of the conduct of outside directors is sure to follow, as is the level of angst among such directors. New focus must be placed on what protections are afforded outside directors and what these directors can, and should, do – short of resolving to never again accept membership on a board of directors and resigning their current positions – both to better serve the shareholders of companies on whose boards they sit and to better protect their self-interests.

Foreshadowing Liability

The fate that befell the WorldCom and Enron boards of directors was foretold in the 1996 case involving Caremark.** Caremark's board of directors was sued for breaching its fiduciary duty in connection with Caremark's violation of the Federal Anti-Kickback statute and other charges. These violations cost the company $250 million in fines and penalties. Disgruntled shareholders sought to recoup those funds from the board but were thwarted when Chancellor Allen of the Delaware Chancery Court approved a settlement of the case noting that there "was no substantial evidence" to support the claim that the company's directors had breached their duty of care. Chancellor Allen appeared impressed that Caremark had in place certain compliance and control measures – an Audit Committee and an Ethics Committee – which, while ineffective, illustrated that the board had fulfilled its duty of good faith and due care.

Directors of companies formed in Delaware – a favored location for many reasons – gain additional protection from the application of the business judgment rule, which reflects the legal notion that decisions by fully informed directors should not be second-guessed by courts, absent a conflict of interest. Directors will be protected by the business judgment rule if they satisfy their main duties to the corporation – the duties of loyalty, care and good faith. Such protection will shield directors from liability even if decisions of the board of directors can be objectively viewed as poor, provided that the directors have satisfied their fiduciary obligations. Moreover, directors who rely in good faith on corporate records or reports, opinions or other statements provided by corporate personnel will be likewise protected. The key to all of these related protections is the requirement that directors not ignore red flags raised in materials presented to them. In addition, directors must demand information and ask appropriate follow-up questions where necessary.

Effective Compliance Procedures Required

Although the Sarbanes-Oxley Act's demands for audit committees, independent directors and other requirements are well known, in the current environment it is simply not enough for a company to implement a program that follows the letter of the law, but is wholly ineffective in dealing with real-world problems that arise. Surprisingly, senior officials at many companies currently under investigation don't seem to understand this, believing instead that it is appropriate to do little or nothing when faced with fraudulent conduct as long as they act in accordance with company policies. When faced with wrongdoing, these company officials must have a mechanism in place (whether it be a compliance officer or committee, or some other outlet) that allows them to express their concerns about certain activity and which may undertake independent investigations of complaints, where necessary.

Steps Directors Should Take

In light of the scandals that resulted in the passage of the Sarbanes-Oxley Act, and all of the related corporate governance mania that has ensued, directors must be zealous about

* On February 2, 2005, the WorldCom settlement collapsed and the trial is scheduled to begin at the end of February. As New York State Comptroller Alan Hevesi indicated in a press release following the scuttling of the settlement, the court "did not rule against the personal payments by [the outside directors] and that is not the reason for the termination of the settlement. The settlement is being terminated solely because of the impact on the amount other defendants might pay if the suit is successful."
** Caremark International Inc., Derivative Litigation, 698 A.2d959 (Del. 1996)

availing themselves of all available tools of protection. Careful adherence to accepted, well-established "best practices" can provide directors with some comfort and, ultimately, protection from liability. So, what affirmative steps can prospective directors take to protect themselves?

For starters, before accepting a position as an outside director, a certain amount of due diligence on the company offering the board seat is strongly advised. Prospective directors will want to confirm that a company's charter contains a provision eliminating to the fullest legal extent directors' liability; the existence of an internal audit staff; the membership of other experienced and well-qualified outside directors and general counsel; and that the company has implemented a code of conduct that complies with applicable regulatory requirements. In addition, directors should have written indemnification agreements affording them full legal protection, as well as appropriate levels of D&O coverage and additional coverage to provide protection when coverage has been denied or insurance has been depleted.

Once they've accepted their positions, outside directors must be more engaged in company activities, require more information when necessary, and make certain that appropriate controls are in place to ensure that the board of directors is attuned to problems before they develop into scandal. Steps that outside directors should be taking include:

- Increase the frequency and number of board and committee meetings
- Spend the time necessary to understand information provided to the board
- Hold meetings with key employees other than the CEO and CFO
- Ensure that the requirements of the Sarbanes-Oxley Act have been implemented, including internal financial controls, audit committee requirements and whistle blower protections
- Meet periodically with the company's general counsel, outside counsel and auditors
- Maintain records to demonstrate careful deliberation of potential red-flag issues
- Carefully review executive compensation and all transactions with officers or directors that raise conflict of interest issues
- Insist that serious issues and problems are discussed thoroughly and appropriate solutions are designed
- Make certain the company has a chief compliance officer with real power to handle major problems

Directors also need to make sure that companies develop and maintain an effective corporate compliance program. Essential pieces of such a program include:

- Full support of senior management
- Educational programs for all employees – not just newly hired employees
- A system whereby concerns about corporate conduct can be made (e.g., Ethics Hotline)
- A policy of non-retaliation for honest reporting of improper corporate conduct
- A committee or compliance officer who will evaluate complaints and take appropriate action
- The ability to conduct a full and impartial investigation of any complaints
- Periodic reporting to the board as to the effectiveness of the compliance program
- Maintaining the compliance program's integrity by reporting the results to the complainant

Effectiveness is an essential component of a company's compliance program and is also necessary for the protection of directors. For example, if a board member sees that, after a lengthy period of time, there have been zero complaints to the company's Ethics Hotline, affirmative steps need to be taken to ascertain whether the Hotline is effective; if it is not effective, directors should encourage the company to take appropriate steps to improve it.

Being proactive is the key to liability avoidance, as the failure to take action may create the next wave in the ever-broadening trend to seek to hold directors personally responsible. This is one trend in which nobody wants to participate.

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