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News flash

Up close and personal: New assault on directors' pockets

As the number of fines imposed on executive officers increases, and the demands of aggrieved shareholders become personal, taking on the role of the executive officer is becoming a risk in itself. The perceived need for directors themselves to contribute to compensation will have implications for D&O insurers. Nilam Sharma **and** Jana Ratnajothy **comment on the converging trends in the US and UK.**

WorldCom

10 of the 12 former non-executive directors of WorldCom have reportedly agreed to settle the class action brought against them for their alleged failure of duty in the company's bankruptcy. The reported settlement is $54 million.

Press reports suggest that the 10 directors have agreed to contribute personally 20% of their net wealth as part of the overall settlement deal, representing a sum of $18 million, or 33% of the deal.

The directors do carry liability insurance, reportedly in excess of the $36 million required to make up the deficit, however one of the company's institutional investors, the New York State Common Retirement Fund, insisted that any settlement deal should include personal contributions from the non-executive directors themselves. Liability insurers will therefore only cover 2/3 of the settlement, and the available insurance reserves will not be fully exhausted.

Recent reports suggest that the court has declined to remove the 10 settling directors from the class action, and judicial approval of the settlement itself is still pending. Despite this, the WorldCom settlement negotiations illustrate that personal liability of directors remains at the top of the international corporate agenda. The WorldCom settlement represents the third of its kind in the US, after Enron and Global Crossing Ltd reached similar settlements in class actions brought against them.

Enron

The Enron settlement involved 10 former directors, who agreed to pay $13 million toward the $168 million settlement of a shareholder class action for compensation arising from the company's collapse in 2001. The $13 million contribution reportedly represents the insider trading proceeds received by the directors prior to the company's collapse.

The agreement was reached on a confidential basis in October 2004, but comprehensive details of the terms were not disclosed until 8 January 2005, just days after the WorldCom announcement.

> Personal liability is a valuable tool in ensuring executives diligently execute their duties

As part of the deal, the sum representing the remainder of the cover available under Enron's insurance policy, approximately $200 million, was paid into court. This settlement agreement has broad implications for former executives who were not part of the agreement, including Kenneth L. Lay, the former chairman, and Jeffrey K. Skilling, the former chief executive officer, as their insurance cover has been heavily depleted. Lay and other officers reportedly still have some $13 million available to pay legal fees, but it is likely they will have to pay **any future judgments against them with their own money or personal insurance**.

Global Crossing

The Chairman of Global Crossing, Gary Winnick and other executive officers, were sued in 2003 for allegedly inflating profits as the company headed towards the largest ever telecoms bankruptcy seen in the US.

The executive officers were accused of participating in capacity

swaps that inflated revenue. 14 months after the claims started rolling in, Gary Winnick settled the claims by agreeing to contribute personally $55 million to the settlement package, which was some $30 million more than he had originally offered. The bulk of the settlement, $270 million, was paid by Global Crossings' executives' director and officers' insurance policy. To put that in context, Gary Winnick had made profits of more than $860 million when he sold Global Crossing stock!

Executive Officers' Personal Liability

We are currently experiencing the most litigious D&O liability environment in history and, in many cases, the financial losses suffered by shareholders and stakeholders far exceed the limits of any D&O liability insurance policy. Wronged shareholders, who have lost significant sums of money, are seeking justice. Public censure and reputational consequences are no longer considered to be appropriate redress by these groups, and they are going after the personal assets of board members. Such action sends out very clear messages to those in positions of power.

Corporate Governance Reforms

As well as pressure from shareholders, executives are also trying to get to grips with the raft of corporate governance reforms implemented in the wake of the Cadbury, Turnbull, Smith and Higgs Reports. A report published recently indicates that non-executive directors are working much longer hours, on average 26% longer, without a corresponding rise in pay!

Paradoxically, non-executive directors are reporting a marked drop in their collective control of chief executive officers, especially those who have large stakes in the companies they run. They are also reporting that they consider their power in controlling directors' pay, and corporate governance compliance, is decreasing.

This is surprising, given the recommendations in the Higgs Report that the role and accountability of non-executive directors should be increased, and is perhaps anecdotal evidence that corporate governance is no longer as high a priority as it was 2 years ago. However, shareholders are evidently astute, and have demonstrated that they know exactly when to step in and apply added, and much more personal, pressure to focus the minds on the board!

Regulatory Aspect on both sides of the Atlantic

SEC

In the US, the SEC continues taking a hard line. In a speech given on 20 September 2004, the Director, Enforcement Division, indicated that the SEC's future enforcement program in the US reflects 3 themes: "*the first is the fundamental significance of gatekeepers in maintaining fair and honest markets; the second is the importance of maintaining integrity in the investigative process aimed at ferreting out securities law violations; and the third is the need for* ***greater personal accountability and deterrence at the top of the corporate world***".

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FSA

In 2004 the FSA began imposing fines for regulatory breaches on the individual officers of companies. In March 2004 the FSA fined Sportsworld Media for breaches of the listing rules, and also fined its CEO (£45,000) for being knowingly concerned in the breach.
In May 2004, the FSA fined the former CEO of Universal Salvage £10,000, for being knowingly concerned in failing to promptly notify the market of the loss of a major contract.

Most recently, in December 2004, the Managing Partner of Indigo Capital LLC was fined £290,000, as compared to a fine of £65,000 on the company, in relation to market abuse offences arising from inaccurate disclosures made to the market.

At the FSA's enforcement conference in September 2004, the message from the Regulator was that whilst enforcement action is a powerful tool and strong deterrent, it recognises the need to strike a balance which will not deter responsible, experienced and qualified people from working in the financial services industry. Although the FSA is not looking for the scalps of high profile individuals per se, it does recognise such action sends out a "very powerful message".

The Regulators are sending out clear and consistent messages regarding personal liability

The attitude on both sides of the Atlantic remains largely aligned, and whilst the frequency of personal fines remains relatively low at present, the Regulators are sending out clear and consistent messages regarding personal liability.

Conclusion

Taken together, the rising threat of shareholder action, increasing corporate governance burdens and diminishing control of powerful executive officers paints a rather gloomy picture for the aspiring director - the trend of increasing personal liability is set to continue.

The message is a simple one: executives must do their job well and, in doing so, exercise sound judgment based on an understanding of the companies on whose boards they serve, or face the consequences.

One wonders whether the net result, in the short term at least, will be poorer corporate governance as potential directors/officers decide the burdens of the job are simply not worth taking on.
The picture for Insurers is complex. As the D&O liability landscape changes, there is certainly the potential for innovative underwriting. We have already seen the emergence of modern policies that offer:

- non-rescindable cover;
- non-indemnifiable cover
- defined sub limits for, or respond exclusively to, certain board members or groups of members; and
- non-executive director coverage, where the underlying D&O policy itself will not respond.

It is safe to assume that recent events will result in an increased demand for Personal Director Policies, i.e. policies that offer non-executive officers personal coverage in respect of independent positions they hold, similar to the professional indemnity policies held by self-employed consultants. Of course, this will not assist where, as in the WorldCom and Enron cases, settlement is dependant upon very public, personal contributions from the executives themselves.

Should you require any further information regarding issues concerning Financial Institutions and/or Directors and Officers Liabilities, please contact any member of the Financial Institutions Team at Robin Simon LLP.

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