Analysis Reveals Low Director Liability Risk

Even in today's post-scandal environment, outside directors will rarely be held personally liable in a shareholder lawsuit.

By Michael Klausner

Board members' angst over the risk of personal liability has been high ever since the outside directors of Enron and WorldCom had to pony up millions. But a careful analysis shows that the threat is vastly overblown. In a recent study, Bernard Black of the University of Texas, Brian Cheffins of the University of Cambridge, and I found just 13 cases since 1980 in which outside directors made out-of-pocket payments. Nearly all involved scenarios that can be avoided today with state-of-the-art D&O insurance, reasonable coverage limits, and proper board processes. Only one trial has ever resulted in personal payments: *Smith v. Van Gorkom* in 1985 (see sidebar).

The other 12 cases settled before trial. Of these remaining 12 cases, eight were shareholder suits for disclosure failures that violated securities laws; one was an SEC enforcement action; and three were corporate lawsuits brought by shareholders or creditors. Personal payments occurred primarily in cases stemming from conflict-of-interest transactions and disclosure violations in connection with a public offering, where securities laws hold directors to a higher standard of conduct. Personal payments also occurred primarily where the company was insolvent. As long as a corporation is solvent and the outside directors haven't engaged in self-dealing or intentional dereliction of duty, companies are permitted to indemnify them for litigation expenses, amounts paid in settlement, and in some cases, amounts paid pursuant to court orders.

Inadequate D&O insurance is the last line of defense for directors of an insolvent company. Of the 12 settlements we uncovered, six involved companies with inadequate D&O insurance coverage; two involved companies with no D&O insurance; and one involved a company with an insurer that had gone insolvent.

Of the remaining three cases, the directors made payments despite having adequate insurance. Each of these involved some form of self-dealing, where D&O insurance offered no protection. One of these cases, Tyco, involved an SEC action against a director. The SEC does not allow either indemnification or insurance coverage for payments made to resolve its enforcement actions.

Finally, there was one case where the company had reasonable coverage limits, no gaps in coverage, and where the D&O policy was fully paid out, and yet the directors still made out-of-pocket payments. That was the Enron case where securities violation occurred in the context of a public offering, and the company was insolvent. Also, the fraud was so enormous and potential damages so high that no amount of D&O insurance would have covered the directors' potential liability.

Since publishing this study, one additional case has been reported in which outside directors apparently made personal payments. This case involved Just for Feet, the defunct shoe retailer. In that case, the company was insolvent and its D&O insurance had run out.

Notwithstanding WorldCom, Enron, and Just for Feet, outside directors remain highly unlikely to face personal liability. The factors that lead to personal liability are insolvency, inadequate D&O insurance, and either disclosure violations related to a public offering or a conflict of interest. The confluence of these factors is rare. Boards can protect themselves by carefully following procedures when addressing potential conflict-of-interest transactions and when performing due diligence related to a public offering. Boards can further protect themselves by obtaining expert advice in negotiating the terms of their D&O policy in order to avoid gaps in coverage and to purchase reasonable policy limits.

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Case Study

Only one case resulting in personal payments ever went to trial: the *Smith v. Van Gorkom* case in 1985, which triggered a nationwide outcry by management, the defense bar, and the D&O industry, and led to changes in state corporate law. In *Van Gorkom*, the Delaware Supreme Court held that the board of Trans Union unnecessarily rushed to sell Trans Union to a company controlled by the Pritzkers, and so failed to adequately consider the sale price. The Court held the individual directors liable for breach of fiduciary duty, and the parties settled to avert further proceedings.