BLB&G

Bernstein
Litowitz
Berger &
Grossmann
LLP

INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

First Quarter 2005

BEYOND CRIMINAL PROSECUTIONS: MAKING THE "GATEKEEPERS" DO THEIR JOBS

By Timothy DeLange

Beyond the criminal crackdown and increased sentencing guidelines, a new system of checks and balances has awakened, holding the "gatekeepers" of our capital markets — outside directors, auditors and underwriters — more accountable when a fraud is perpetrated by corporate insiders. As demonstrated by the directors' and underwriters' recent settlements in *WorldCom*, the trial of the Disney directors, and the quick ouster of AIG Chairman and CEO Maurice Greenberg, to cite just a few examples, institutional investors are focusing on the accountability of the corporate "gatekeepers" more now than ever before. In addition to Enron and WorldCom, there is a long list of recent, high-profile public company debacles, including AIG, Adelphia, Tyco and Hollinger, to name a few, which have reinforced the belief that the so-called "gatekeepers" of public companies too often are not performing their oversight function and have not been sufficiently incentivized to do so. Now, however, they are increasingly being faced with the reality of having to dig into their own pockets for their failure to protect the investing public, and it is making a significant and positive difference for investors.

For example, on a single day in January, the face of liability for outside directors was changed dramatically. On January 7, 2005, the New York State Common Retirement Fund, lead plaintiff in the *WorldCom* class-action, announced an historic settlement where the former directors of WorldCom will personally pay millions of dollars. Thus, in *WorldCom*, the 11 former directors will dig into their own pockets to fund $24.75 million of the total settlement, or slightly more than 20 percent of the directors' combined net worth!

In WorldCom, the 11 former directors will dig into their own pockets to fund $24.75 million of the total settlement, or slightly more than 20 percent of the directors' combined net worth!

Historically, it was virtually unheard of for outside directors to pay personally to settle a securities fraud class action. According to a preliminary review conducted by a professor at Stanford Law School, from 1968 through 2003 directors contributed to a settlement out of their own pockets only four times — and those were minimal payments. This groundbreaking settlement highlights a new chapter in the backlash against corporate malfeasance in which the "gatekeepers" are being pushed to bear much higher personal costs for failures in supervision.

The fallout from the *WorldCom* settlement was immediate. Within days of the announcement of the settlement, several of the largest and most prominent securities defense firms responded with memorandums to their corporate clients addressing the implications of the settlement and providing guidelines and suggestions for countering the potential impact of this historic settlement. Among the suggestions and advice offered to boards and individual directors was: (i) keep informed of all corporate developments and be active and attentive, dedicating the time necessary to prepare for and participate fully in all meetings; (ii) carefully review any transactions involving management participation; (iii) keep a close eye on the ethics and integrity of management and use the assistance of outside counsel, accountants and other experts who are advising the company on critical issues; and (iv) review the company's D&O insurance, including separate "Side-A" insurance covering the directors separate and apart from the corporation. Such coverage is especially important should the company file for bankruptcy, as happened in both *Enron*

Continued on page 2.

and *WorldCom*. Indeed, just last month, Merrill Lynch & Co., the world's largest securities firm with capital of $199 billion, revealed a new type of insurance to protect its directors, executives and employees from delving into their own pockets should the company go bankrupt. Last year, Merrill established a "credit-default" agreement that would pay as much as $140 million to a trust in the event Merrill becomes insolvent. The trust would use the money to reimburse directors and employees for any personal loss stemming from legal claims. Although Merrill already has traditional directors' and officers' liability insurance, the credit-default arrangement will provide additional liability protection.

While companies are busily trying to insulate their directors from personal liability, one could reasonably ask — aren't the suggestions above what outside directors should be doing in the normal course of their duties? Why should it have been necessary for this unprecedented settlement to serve as a wake-up call to outside directors to do what they should be doing all along — and are getting paid handsomely to do at that?

The two-month *Disney* trial — now completed and awaiting a decision from Delaware Court of Chancery Judge William Chandler III — demonstrates just how far the latest phase of corporate accountability has progressed. At trial, plaintiffs focused on how the Disney Board of Directors allowed shareholder money to be used to pay Michael Ovitz's $140 million cash and stock severance after barely a year of service as President. At issue is whether the directors honestly and in good faith believed they were acting in the best interests of the shareholders when they rubber-stamped the pay and severance package of Ovitz by his close friend, former Disney CEO Michael Eisner.

The increased activism towards the accountability of outside directors is not limited to institutional investors, such as those who are leading the *Enron* and *WorldCom* cases. Stephen Cutler, Director of the SEC's Division of Enforcement, warned in a September 2004 speech, "Over the next year, we intend to continue focusing closely in our investigations on whether outside directors have lived up to their roles as guardians of the shareholders they serve." Indeed, the SEC — often criticized for having missed large problems in the past — has been moving faster and more aggressively when cases arise. Asset freezes, lifetime bars preventing individuals from serving as corporate officers and directors, and financial sanctions all reached record levels last year, according to SEC data.

The increased activism towards the accountability of outside directors is not limited to institutional investors…Indeed, the SEC — often criticized for having missed large problems in the past — has been moving faster and more aggressively when cases arise.

For example, in September of last year, the SEC announced a settlement with Electro Scientific Industries general counsel John Isselmann, Jr., who became the first company lawyer to be penalized for "gatekeeper" violations under the Sarbanes-Oxley Act. According to the SEC, "he had information that he should have passed on to the board and the company's external independent auditor. If that information had been presented, it would have prevented the financial fraud." Under the settlement, Isselmann will pay a $50,000 civil penalty and refrain from service as an officer or director of any public company. In addition, KPMG LLP recently agreed to a settlement in connection with its role in the Gemstar-TV Guide accounting fraud that includes a censure and $10 million payment to shareholders, the largest amount paid by an accounting firm in an SEC action. The individual auditors at KPMG — all certified public accountants — agreed to suspensions from practicing before the SEC. Finally, the SEC is tightening its policy on forcing individuals to pay their fines out of their own pockets, recently requiring directors that are settling SEC enforcement proceedings to represent in writing that they are not being indemnified for any fines they have agreed to pay in connection with the settlement.

There is little doubt the historic settlements in *WorldCom* and *Enron*, and the increased activism of the SEC, have created a new paradigm in corporate boardrooms across America. Rather than sitting back and relying upon the security of D&O insurance, directors and other "gatekeepers" now face the reality of writing a personal check to cover losses caused by their failure to adequately perform the duties they were entrusted with. Through the activism of institutional shareholders, directors and other "gatekeepers" can now expect to pay for failing to be diligent and independent in fulfilling their fiduciary obligations to shareholders.

Just witness the record $6 billion paid by WorldCom's underwriters in settlements in that action led by the New York State Common Retirement Fund. These settlements amounted to over 60 times the fees the underwriters received from WorldCom for their work. The settlements (and the heightened duty of underwriters as established in the decisions of the Court in that case) will be the subject of a lengthy article in the next issue of the *Advocate* — STAY TUNED!

Timothy Delange, the current Editor of the Institutional Investor Advocate, *is an associate in the California office of BLB&G. He prosecutes securities actions on behalf of the firm's institutional investor clients. He can be reached at timothyd@blbglaw.com.*