

Director liability update

Assessing corporate directors' potential personal liability **By Laura Holm**

Corporate scandals at Enron and WorldCom have raised new issues of potential personal liability for directors. The outside directors of WorldCom, now MCI, agreed to pay \$55.25 million, including \$25.75 million of their own money, to settle part of a class-action lawsuit brought by investors.

Ten of the 18 outside directors of Enron agreed to pay \$13 million of their own money to settle a \$168 million lawsuit.

These settlements highlight a trend toward imposing greater duties on corporate directors. Although both Enron and WorldCom are clearly mega-companies, these settlements have likely set precedent for companies of all sizes.

Evolving theories of director liability

Every director should understand that a company's directors have well-established fiduciary duties to the corporation and its shareholders. The principal duties owed by directors are the duty of care and the duty of loyalty.

The duty of care obligates a director to act on an informed basis, in good faith and in a manner he or she reasonably believes to be in the best interests of the company. The duty of loyalty obligates each director to put the interests of the company ahead of his or her personal interests and refrain from self-dealing, usurping corporate opportunities and receiving improper personal benefits.

New law is emerging in which a corporation becomes insolvent or is in the zone of insolvency. In such a situation, officers and directors continue to have fiduciary responsibilities, but they are no longer limited to the corporate entity and its shareholders.

Directors must also consider the interests of the company's creditors. The courts have not definitively decided whether the shift in directors' fiduciary duties should be in favor of creditors to the exclusion of shareholders.

In general, the evolving case law supports some continued obligation to shareholders, along with new obligations to creditors, setting up situations where directors must balance the interests of both.



Minimize personal liability

Directors can take certain actions to minimize the company's liability, as well as their personal exposure to liability, by taking the following steps.

■ **Establish and maintain rigorous compliance programs.** Directors should ensure that the corporation is in compliance with all of its regulatory and statutory obligations. Directors can, in certain circumstances, be held personally liable for the company's failure to pay certain withholding and sales taxes, franchise taxes and employee wages.

Directors may also incur personal liability for the company's failure to comply with other regulations, including, but not limited to, regulations relating to the environment, ERISA plans and the Sarbanes-Oxley Act. Therefore, the company should set up a program to ensure compliance with all statutory and regulatory obligations.

■ **Seek timely legal and financial advice on transactions.** Because outside directors are not generally involved in day-to-day activities, their risk is greatest with significant corporate transactions that are the purview of the board.

Mergers, acquisitions, major dispositions, restructurings or the like are transactions where it is critical that the board receive competent financial and legal advice.

Prudent directors will ensure that they fully understand the transaction and have fully absorbed the advice of the board's advisers.

Any transactions with insiders, which include employees, officers, directors and significant shareholders, must be subject to scrutiny.

■ **Be even more careful if the company becomes troubled.** When a company is insolvent or near insolvency, prudent directors will consider the interests of the corporate enterprise as a whole, taking into account the interests of creditors, employees and customers, as well as shareholders.

Getting competent legal and financial advice becomes even more critical as additional factors and transactions come into play.

Serving as a corporate director is a very serious commitment. All directors would be wise to thoroughly understand their duties and responsibilities, especially when serving on the boards of troubled companies.

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