Despite Worries, Serving at the Top Carries Little Risk

The Myth of Accountability for Corporate Directors

By Steven M. Davidoff

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They are paid millions, but some complain that it's no longer worth it.

These men and women argue that, as corporate directors and officers, they have too much chance of liability for a company's operations. Because of this, they claim, the risks of serving as a director or officer have become too great, and it will become harder to recruit and retain competent directors and officers. But the truth is that they have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning.

The day-to-day management of a company is largely regulated by state law. Since most companies are incorporated in Delaware, this means Delaware law. And Delaware law on this matter sets an extremely high standard for finding directors and officers liable for a company's mismanagement. A Delaware court is not going to find them liable no matter how stupid their decisions are. Instead, a Delaware court will find them liable only if they intentionally acted wrongfully or were so oblivious that it was essentially the same thing.

Under this standard, a Delaware court recently refused to hold Citigroup's board accountable for its decision to enter the subprime mortgage market, a decision that resulted in billions of dollars in losses and the company's near failure. The boards of Bear Stearns and Lehman Brothers are also scot-free so far.

And only last week the board and management of Massey Energy won a case in Delaware Chancery Court that would make it significantly more difficult for them to be held liable for their ostensible poor oversight of the company's safety practices that led to the Upper Big Branch mine explosion and the death of 29 men.

Even if there is liability or a settlement, it is almost always covered by insurance of directors and officers. One study found that from 1980 to 2006, there were only two instances of directors of a company incorporated in Delaware being required to personally pay for their misconduct.

One of those involved litigation against the board of Fuqua Enterprises. The Fuqua directors had the unfortunate luck to be insured by Reliance Enterprises, which

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Although they claim the risks are great, the truth is that corporate directors have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning.

went bankrupt. They paid an undisclosed portion of a $7 million settlement.

The other known personal liability case involved the sale in 1980 of the TransUnion Corporation. The 10 TransUnion directors paid a total of $1.35 million. There you have it, no more than $8.35 million in personal payments by directors over more than 26 years.

There can also be liability for board members and executive managers under federal law. These are largely securities fraud cases where the directors or officers make a misstatement or omission.

This has nothing to do with the oversight of the company, but often there are misstatements about accounting or the company's financial condition. Instances of personal liability for officers and directors in these cases are only a bit less rare, again because the standards are high and insurance often covers the matter.

The same study found only nine cases where a director was held personally liable for securities fraud in a 26-year period. Three of these were highly notable — Enron, WorldCom and Tyco.

And no directors from the financial crisis have yet been found liable under these laws. Officers are faring just as well, and the only prominent payment was by Angelo R. Mozilo of Countrywide Financial Corporation. He paid $22.5 million of a $73 million fine. The rest was paid by Bank of America. Meanwhile, the fines of David Sambol, Countrywide's former president, and Eric P. Sieracki, the ex-chief financial officer, were paid in full by Bank of America.

The only financial crisis case to go to trial, involving officers of BankAtlantic, had its jury verdict finding civil liability overturned by the judge. And unlike with Enron and WorldCom, it seems there will be no criminal cases involving securities fraud stemming from the financial crisis.

What about the Dodd-Frank financial reform, you might ask? It doesn't change much. The main provision concerning the personal liability of officers and directors involves systemically important financial institutions, or the "too big to fail" entities. And if one fails, Dodd-Frank authorizes the Federal Deposit Insurance Corporation to claw back two years of compensation from those held substantially responsible for the failure.

This is a weak penalty. An economically important bank with hundreds of billions of dollars in assets fails, and the penalty is only two years of pay? Nonetheless, the Securities Industry and Financial Markets Association and a number of other industry groups objected to the FDIC's proposed rules on this requirement. The financial industry groups again argue that such a standard will drive away directors and officers as well as make it harder to recruit these people.

This is laughable. First, we've already seen that liability for boards and management is extremely rare. Moreover, many of the directors of Lehman and Bear Stearns continue to serve on other boards, and one Lehman director, Jerry A. Grundhofer, has apparently been so chastened about the liability issue surrounding large banks that he is serving on the Citigroup board.

More telling, there is no empirical evidence whatsoever supporting this argument. Instead, you have the occasional self-serving statements by officers and directors that they are resigning because of "liability"

reasons. Officers in particular like to say that they are taking a company private for this reason. But more often than not, it is because there is more money in being private.

This is not to say that it has not become more difficult to be a director or officer. Regulation has certainly increased. So has scrutiny. This has made the work of being a director or officer of a public company harder and more time-consuming. And yes, if a company declares bankruptcy, these people will lose a lot of their investment and may in rare circumstances have to pay back some of their salary.

But is that too much to ask? According to a recent study by Equilar for *The New York Times*, the median salary of a chief executive at the top 200 major companies was $9.6 million last year. Salaries for chief financial officers at companies listed on the S&P 500 stock index shot up last year by 26.1 percent, according to Equilar, and the median salary is now $3 million.

The prominent law firm Wachtell, Lipton, Rosen & Katz recently issued a memorandum calling for director salaries to increase because of the increased burdens on this position. Outside director salaries average about $200,000 for *Fortune 500* companies, according to global consulting firm Tower Watson.

The upside of serving as a director or officer thus appears huge. The downside is very limited. Yes, there will be increased regulation to comply with and some of it may even be unjustified, but that conflates liability with regulation. Remind directors and officers of this the next time they complain about the risk they are taking because of their jobs. ◆

More on the Myth of Director Accountability

A Little Fear Can Go a Long Way

By Mark Lebovitch
and Jeremy Friedman

Challenging the common lament that the risk of personal liability deters good people from serving as corporate directors — and that salaries must be high as a result — Professor Davidoff points out that officers and directors "have about the same chance of being held liable for their poor management of a public firm as they have of being struck by lightning."

While personal liability has always been rare, corporate directors once knew that if they did not try to do their jobs or were blatantly asleep at the switch, they faced some risk of liability. Although the legal standards governing director behavior have not materially changed in years, recent decisions indicate that how judges apply those standards may be less protective of shareholders than in the past.

While many factors may combine to sway the application of law in a particular direction, we believe one reason for softening judicial oversight of directors in recent years may be the Delaware Supreme Court's opinion in *Ryan v. Lyondell*. The trial judge in that case declined to dismiss claims against directors and required them to stand trial to determine whether "two months of slothful indifference [by the defendant board] despite knowing that the Company was in play" (that is, considering a potential sale) amounted to bad faith. Although the judge's opinion showed his skepticism of the shareholders' position, he held it was a close enough call that a trial was merited.

The corporate community publicly attacked the judge for daring to make the directors sit through trial. The Delaware Supreme Court not only reversed the judge, but it seemed to rebuke him for his decision. The resulting backlash was applauded by Wall Street and corporate CEOs, and it undoubtedly sent a clear message to Chancery Court judges (and even other judges) considering whether to hold directors personally liable.

As Davidoff's article demonstrates, the status quo essentially guarantees that directors face no risk of personal liability, regardless of their conduct. In our view, the benefits — to shareholders, corporations, and the economy in general — of judges casting even a slightly more critical eye on director conduct far outweigh any risk of misplaced personal liability. ◆

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