DIRECTOR LIABILITY*

ABSTRACT

This article contains the edited transcript of a forum on personal liability of directors held at Harvard Law School in November 2005. Eleven panelists offer their diverse views and perspectives on this subject. The participants in the panel, which is moderated by Lucian Bebchuk, are: Joseph Bachelder, Roel Campos, Byron Georgiou, Alan Hevesi, William Lerach, Robert Mendelsohn, Robert Monks, Toby Myerson, John Olson, Leo Strine, Jr., and John Wilcox.

LUCIAN BEBCHUK**: Let me begin by saying a few words about the subject that brought us here today. In January 2005, settlements were announced in two important cases—Enron¹ and WorldCom.² The terms of the settlements were unusual. They involved the directors of the companies making some payments out of their own pockets. Richard Breeden, former SEC chair, called these settlements a "watershed development" that will send a shudder through boardrooms across America and could change the rules of the game.

While there is a substantial agreement that these developments could considerably change the rules of the game, there is considerable disagreement as to whether such a change would be positive or negative. To explore this question, we have with us today a remarkable panel of eleven distinguished speakers who will offer us their views and perspectives. I would like first to pose a question to each of the panelists. Let's start with Alan Hevesi, Comptroller of the State of New York and the sole trustee of the NY State and Police Pension Fund. Alan played a key role in the plaintiffs' decision to insist on personal director liability in the WorldCom case. Alan, can you tell us about the reasons that led to this decision.

ALAN HEVESI*: Yes, Professor. Thank you for the invitation and I will try to be as brief and summarize as quickly as I can my rationale for asking our lawyers to negotiate a settlement with the directors that included them paying out of their pockets. I don't know if it was unprecedented but it was not the rule. Normally in the securities cases the directors, if they were found liable for any behavior, issues, or failure to perform due diligence, the insurance covered that. And I insisted that they pay out of their pockets. This was an exceptional case.

WorldCom is the largest fraud in history. It's $11 billion in false filings, $40 billion in damages, $76 billion in restatements. Thousands and thousands of people lost their jobs with the bankruptcy. Thousands, tens of thousands of retirees lost all or part of their pensions, and the WorldCom case is special in another way. It was the critical mass after a series of other frauds—Tyco, and Global Crossing, and Enron, and so on. I have a long list but I'm not allowed to spend the time reading them which has an impact.

But at WorldCom, there finally came a recognition by the public that these frauds were now affecting "me," not just the people who lost their jobs and the pensioners and the people in the universe of the companies that were being accused. The end result was a dramatic effect on the economy that the Brookings Institution measured in the first year after these scandals were revealed as costing the U.S. economy $35 billion. That's a whole other issue, but why did we insist?

I took the position, not being a lawyer—I may be the only non-law student or lawyer in the room—that I didn't know why directors were, in the face of judge's decision that the fraud was blatant and clear and obvious by the managers of the company—by Bernie Ebbers and Sullivan and others—why they should not be held liable as everyone else might be liable—the underwriters and others who could be proven not have performed due diligence.

There were four pieces of information. One was the enormity of the fraud. Second, there were three separate independent investigations. Richard Breeden was assigned by the court to review as a monitor. The former attorney general Richard Thornberg, the bankruptcy court examiner, and then the board's own report that indicated that the board of directors themselves had failed in their responsibilities to oversee the operations of the management. Their audit committees spent between three and six hours a year overseeing the auditing and financing. They failed to supervise their internal audit department. They approved major acquisitions with little or

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no deliberation and no paperwork, a $2 billion acquisition of Skytel Communications in a fifteen-minute meeting and a $6 billion acquisition of Intermedia in a thirty-five-minute meeting. No paper, no nothing—they just signed off on it and this—Intermedia—was a disaster for the company and for the shareholders.

They allowed debt to spiral in the company to $36 billion without engaging in any debt planning. Their debt plan was to authorize Bernie Ebbers and Scott Sullivan to borrow at their own initiative without anybody else's approval as long as each individual transaction did not exceed $15 billion. Think about that. So, you could have had two at fifteen, or three at fifteen. They gave blank checks to the CEO and CFO. They authorized hundreds of millions of dollars in loans to Bernie Ebbers for his outside activities and guarantees and wondered why he might have a motive to artificially keep the share value high so he could deal with his own personal issues.

I mean, it's a disastrous failure on the part of the board. What we said was, we're going after the accounting firm, the auditors who didn't meet their obligations—Arthur Andersen. We're going after the underwriters. We finally got a total settlement of $6.1 billion, which is the world record, but maybe for only twenty minutes. Bill Lerach will tell us what's coming at Enron, and why we're holding the directors somewhat responsible.

And what we did get in a settlement, they agreed, was twenty percent of their collective net worth—would go into the settlement—exclusive of their home and their retirements. I think that's eminently fair. Now, we've had a lot of grief from the corporate community that this is somehow going to have a chilling effect in recruiting directors. Well, if you're going to recruit directors who behave like they behaved, or didn't behave, then that's not appropriate. You gotta do your job, and it's not difficult.

Right now, as a result of this decision, lawyers and other are training directors how to go to meetings and ask the right questions and keep a record and read the reports and say what is this all about and I think that's very salutory. If I were a slick politician, I might tell you if you need directors in your company, call me. I'll get them for you. So, I'll stop there and respond later on.

LUCIAN BEBCUK: Bill Lerach, your firm was lead counsel in the Enron case. Can you offer us your and your client's perspective as to why personal director liability was necessary?
WILLIAM LERACH*: Well, the lead plaintiff in the Enron class action is the California Regent's Pension Fund, a large pension fund like Alan's Fund—this one for the teachers and other players of the University of California system, which lost $150 million due to the Enron misconduct. I think the client viewed the Enron situation as an exceptional and extreme fraud. The client felt that it had an obligation, having taken control of the case as the lead plaintiff, to insist on personal accountability from the directors of Enron.

After all, the directors of Enron had waived the conflict of interest policy of the corporation in three separate votes, to permit the CFO of the company to secretly serve as the general partner of an entity that did billions of dollars of illicit transactions with Enron to hide debt and boost earnings. So the directors were actively complicit. Our clients were also motivated by the fact that, for whatever reason, the SEC declined to take any enforcement action against the directors—although, they took action against certain insiders.

Now, Enron was a little bit of a different case from WorldCom in that Enron involved a large amount of insider selling by the directors. So, we focused on the insider selling proceeds as the appropriate way to hold the directors personally accountable. And we made them pay ten percent of the pre-tax gain that they got on their stock sales. Now remember they have to pay tax on the stock sale proceeds, so this really amounts to about twenty percent of what they got from their insider trading. And I emphasize, this was paid only by the so-called innocent or outside directors. This does not include Lay, Skilling, Fastow, Pai and the other insiders who are much, much more culpable.

I think, at bottom, this is an exceptional situation. It will happen in the future but it will be the exception, not the rule. But as Alan said, we felt it was justified. For heaven sakes, if there are no personal consequences to a defalcation of the scope of the director defalcations in WorldCom and Enron, will there ever be any deterrents? And will conduct ever be enhanced? That's what motivated our clients.

LUCIAN BEBCHUK: Let's hear now from a couple of people who are much more skeptical about personal director liability. Toby Myerson, what's your view on the settlements in the Enron and WorldCom cases?

TOBY MYERSON*: Well I don't want to speak in detail about either because my firm is involved on the other side from these gentlemen in both. I will say this, however. Alan suggested in his commentary that the

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underwriters were proven to have engaged in misconduct. In fact, the underwriters settled their disputes and there has been no court decision on that question. So, I just want to correct the record.

As far as state law is concerned, I think the real question is: What are the standards for holding directors responsible? There's a statutory regime in Delaware that basically says that if you're acting in good faith and in a manner that is intended to be in the best interests of the corporation, then, essentially, directors shouldn't have any liability. The debate that follows from these principles is whether these directors performed their duty of care adequately? Did they have personal conflicts of interest which would lead to a violation of the duty of loyalty?

People talk about the chilling effect of some of these settlements. While there are always extreme cases that one can point to, the fact of the matter is that most people who serve on boards of public companies are acting in good faith, thinking hard, working hard, and trying to do the best they can. Being a director is really not a full-time job for most of the people who serve in that capacity.

The critical question is how can the legal regime function so that men and women of intelligence and energy will feel comfortable sitting on the board of directors, doing their job and not fear that they will get second-guessed for investment decisions or other activities that don't necessarily work out. We don't want to discourage risk taking. We don't want to discourage imagination.

From my perspective, giving the directors some space and some room to function, including the ability to make mistakes when they're honest mistakes, is really the way the law ought to function. For the most part it does.

LUCIAN BEBCHUK: John Olson, I know from our conversations that you also are not a fan of personal director liability. Are there any cases in which you think it would be desirable to have outside directors make payments out of their own pockets?

JOHN OLSON*: Lucian, you know I graduated from this law school forty-one years ago. I was going to be a trial lawyer and talking earlier to Byron and Bill about how this all works economically. I think maybe I should be a fan. I mean they're going to receive something on the order, if I understand them, of $700 million gross in legal fees—admittedly after a lot of expenses—in the recovery they've gotten for the investors at Enron.

And that makes it very interesting, frankly, to come up with new theories of liability and to be creative in this area. I also will say, I have

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been dining out with boards of directors, for the last good many months, who wanted to know what this all means for them, both the Enron and the WorldCom settlements. Neither of those particular factual circumstances, I think, is all that surprising, because we're not talking about the legal structure that Toby was just referring to which is state law. In both the Enron and WorldCom cases, the primary legal issue was whether or not there was liability under section 11 of the 1933 Act in connection with the issuance of securities.

How many of you have taken Securities Regulation in this class? [Raising of hands.] Not near enough. But in any event, section 11 basically says that if there's a material misstatement or omission relied on by investors in a document that goes out when you offer securities—and both of these companies offered billions of dollars of debt and equity securities—the company itself is absolutely liable. The underwriters are absolutely liable. And the directors and officers are also absolutely liable to give you your money back—to the extent that there's a material misstatement or omission in that offering document. The company has no defense. But in the case of the officers and directors and underwriters, they can establish that, after the exercise of due diligence, they did not know and should not have known of the misstatement or omission.

The problem legally, as limned out in the preliminary rulings of both of the judge in Texas in Enron and the judge in New York, Judge Cote, in WorldCom, is that, in light of these reports that the Comptroller Hevesi has talked about, the directors were damned before they started, because people had already come in—former Attorney General Thornburgh, and former SEC Chairman Richard Breeden, and made findings that these directors had not done what they should be. According to the Breeden report, not only had they slept while the train went by the switch, they'd been sleeping on the switch. So, they were going to have a very, very difficult time establishing a section 11 "due diligence" defense.

Most directors are smart enough today to get counsel, as the Comptroller was suggesting. They're not likely to be in that situation, one hopes. So I don't have a big problem with those particular settlements. Also, they're very symbolic. Yes, it was twenty percent of the net worth of the individuals settling in WorldCom case, but they left out their homes, all their homes, and their retirement funds, all their retirement funds. And if you know anything about executive compensation you know that that probably was a lot of money that didn't get counted. So, they're not going to go to the poorhouse.

In the overall scheme of these billions of dollars of settlements, this was less than one tenth of one percent of the total. But, it was a good, symbolic prick on the finger, or slap on the wrist and it certainly did cause
interest in board rooms around America—a little bit less interest, interestingly enough, than the Disney\(^3\) case which came out the other way because there you had the prospect that directors might have to come up with up to $140 million from their own pockets if the case was lost.

What all of these cases have done is cause directors to focus a lot more on process. I don't think that's all bad. Process is not the whole story but it's what we can best measure. So, now you have boards getting independent advice, taking more time, spending hours on a proposed acquisition instead of twenty minutes, getting fairness opinions, asking hard questions, and having people like me to tell them what questions to ask. I think that's fun; I don't have to retire now. I can be doing this for a while. Ira Milstein and I can do this until we're ninety, and we will. But there is a cost, not only the transaction costs of getting the money from the pockets of directors and banks and others and into the pockets of the pension funds and other investors (which are not inconsiderable and other systems do it differently and less expensively). But there are also some other costs. For example, one thing I'm seeing is—and I've talked to directors every week really—directors are pruning the boards they are willing to serve on. So they will go on the board of a well-established, cautiously managed, establishment company that's not doing anything very exciting—what we call a cash cow. But, they're much more reluctant to go on the board of a high-tech, high-flyer with the entrepreneur. Now is that good for our system? Maybe not.

So we are, I think, seeing some impact on where directors are willing to serve. It's not that you can't get directors. But there is an impact on the quality of directors you can get, particularly for younger, less established companies. So I don't know as I'd like to see this trend go much further. I think the occasional slap on the wrist in the extreme case is not a bad thing.

And frankly, the law is set up that way. I mean, whatever we think about state law, that's the federal law; it's been the federal law since 1933. If we want to change it, we're going to have to amend the '33 Act. And the SEC would probably think that was a bad idea. And if you go way back, you know, *Escott v. BarChris*\(^4\) and *Feit v. Leasco*\(^5\)—there were cases way back when people did get held personally liable and held to a fairly high standard under the federal statute.

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I think I've said enough now. I'm not in love with the concept of going after people's personal assets because I think often it does cut down on the willingness of good people to serve, particularly on the boards of emerging growth companies where they're needed the most. But I also think that the legal structure is not all that leads to these settlements. If you understand the facts and understand the federal statute involved in Enron and WorldCom, the settlements are not all that startling.

LUCIAN BEBCHUK: Alan Hevesi, may I get a quick reaction from you to the concern that both Toby and John stressed. Perhaps you could comment in particular on the structure of the settlement in the WorldCom case. Each of the paying directors contributed about twenty percent of their net worth, which meant that those with deeper pockets paid more. Could such settlement terms discourage people with high net worth from serving? Is that an effect that you are concerned about?

ALAN HEVESI: In any large universe of people in human activity, you will find an example of every response. There may be very wealthy people who wanted to be on boards and don't want to be now, because they have more to risk at twenty percent if that's the norm in the formula. The point is nobody has to be at risk if they do their job as outlined by the attorneys most of them are now talking to—this is your responsibility.

I thank you for calling on me again instead of others—I apologize, I have to make that 5:00 plane, so I'm out of here in fifteen minutes, with apologies, so—but the bottom line here is there are victims here. There are victims here.

First of all, ninety-nine percent of corporate America are honest, decent people. The executives, the board members—they're victims of these corporate corruption scandals. They're victims of the failure of folks to do their due diligence. They, CEOs, are dealing with Sarbanes-Oxley and reporting requirements. And some of them, you know, any swing of the pendulum goes too far, you might have to come back a little bit—they're victims.

But in the WorldCom case alone, there were 103,000 employees and retirees who participated in the company's 401(b) plan. The numbers that I have (don't hold me to precision here) was at least 22,000 lost their jobs. The retirees lost all or part of their pensions by the tens of thousands. Supplier companies went out. There was huge damage here and so to say to a director—"Do your job."—and to recognize that this was a special case and Bill Lerach was very careful to emphasize that, Enron as well, these are special cases.

But at least they're out there as models to suggest that people should meet their obligations. This is serious business. I believe in my state a substantial percentage of deficits of state and local government—because
New York state has the Center of Financial Services, as a result of these corporate scandals and the unwillingness of some people who enter the markets—citizens who bought stocks and bonds and mutual funds during the boom—who dropped out, combined with other variables—affected our financial services industry. After WorldCom, nearly 35,000 securities industry employees in New York lost their jobs and three other people for every one of those jobs—a total of 147,000 jobs lost and tax revenues.

There's a real consequence here that requires us to set some standard and some limit. That was at least my thought process in approaching this. But, you're right—it was symbolic. It's a relatively small amount of money compared to the settlements, but I think it was an important message.

LUCIAN BEBCHUK: Leo Strine, John mentioned earlier the Disney case. He also suggested that section 11 creates liability that could well be counterproductive and that, in contrast, state law is getting it right. To many outside observers, it seems that the Disney decision sends a clear signal that, under Delaware law, directors don't have to be too concerned about personal liability. Is that a good prediction and an accurate reading of the case?

LEO STRINE*: I think the Disney decision was a reaffirmation of what the law has been. You can have a Delaware corporation where you can seek damages against the directors for gross negligence. That's the default law. Stockholders in approving corporate charters chose to take advantage of the statute that exculpates directors, except when they act, essentially in their self-interest or with scienter, in the sense that they act in some way consciously at odds with the best interest of the corporation. There was a case called Caremark6 that was decided in 1996, which I believe articulated the standard for liability in this context, about the same way the Disney case panned out. And what we're really talking, which is why I think the title of this panel is a misnomer—I mean if what we're talking about is when would outside directors, people who are not financially benefiting from a fraud, or trying to benefit their brother-in-law on the board from a fraud, be liable personally, if that's what we're talking about—then that's a different subject than director liability in general.

My court is the only one in the country that has held Richard Scrushy liable and made him pay anything. My colleagues and I have each held directors liable many times. You've heard of Hollinger. Vice Chancellor Jacobs—now on the Delaware Supreme Court—did the Emerging

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*Vice Chancellor, Delaware Court of Chancery.

Communications case, in which he held supposedly an outside director affiliated with Houlihan Lokey personally liable. We do it. The question is how often should that occur, and what should the standard be?

I wrote an article as Bill Lerach knows, about the implications of Enron for corporate law. One of the things that was driving me nuts was this idea that somehow there was no potential state law claim that could be brought against the Enron directors, when that wasn't true. I understand and I share Alan's concern about the seriousness of these frauds. I think it is a complex issue, though, when you're an outside director.

And I want to add a little bit of completeness: I have no problem with the idea, and in I fully support the proposition, that there has to be the ability to hold an independent director liable when their duty is to act as a monitor and when they consciously disregard that duty. And WorldCom and Enron are exactly paradigmatic examples of the type of behavior that Bill Allen in his Caremark decision described as potentially creating liability. That is, the sustained inattention to serious issues of the corporation over time.

Alan mentioned the short hours of the WorldCom audit committee; I think if you looked at Enron, it's a similar thing. Astonishing lack of attention, in a situation where people, if they looked at themselves honestly in the mirror, arguably they knew they weren't doing their job. They knew they were being paid to do something important. They arguably knew they weren't putting in the effort. If that's so, that's called scienter.

For those of you who, more of you have taken criminal law apparently than securities law, that's not hard given the few number of you taking securities law, but scienter is a state of mind. People go to jail all the time; if you turn your head and run a stoplight, that's called negligence. If you down a bottle of tequila, tie a bandana around your eyes and then drive down the road through stoplights, it may be a form of negligence but since you know you're doing it—you're get put in jail for a freakin' long time. And what we're trying to do is separate out these very disparate situations.

Now let's talk about a complexity, about a liability regime. Do you want people like Bob Clark, who use to be the Dean here, being an independent director? I think you do. Do you want good people doing that? Here's the problem with section 11, and here's the thing, it's not even so much in the liability formulation. The liability formulation probably is

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not all that much different than Delaware, although it looks a little bit like a gross negligence, or a negligence standard. The key difference is that you have to prove your exculpation and you can't do that on the pleadings.

What's the situation? You ever heard of D&O coverage? Directors' and Officers' Coverage? They're not drafted very well, these policies and they cover both directors and officers. Guess who commits the fraud? A lot of them are the officers. Guess what cases go forth, first? The criminal cases. They cost a lot of money. The directors are looking at whether they can even defend themselves—if there's anything going to be left in the policy. If you can't get out on the pleadings, and one of the interesting things if we're talking legal policy, is that section 11 is really an anomaly under the way the federal laws now work. There was a lot of reform to make people plead facts under 10b-5, you had a whole fight about whether the particularized pleading standard, right? And can you create an inference of bad faith? In section 11, it's just the opposite.

JOHN OLSON: Yes, the burden's the other way.

LEO STRINE: The burden's on the independent director. And you can rationally settle a case, not because you think you did anything wrong, but because the officer who actually stole from the till is going to exhaust your insurance policy and you have to pay for your own lawyer. And if you can't make an effective motion early in the case, you can't get out on a motion to dismiss, then you're basically stuck in, in the summary judgment standard. That can create a powerful issue.

And I will say, I think WorldCom and Enron, I would agree with Bill and Alan, I don't think anybody can say that those aren't the kinds of cases where someone like Alan, on a behalf of a big pension fund, as a lead representative, shouldn't be looking to hold people accountable, but I have had much more garden variety cases since then, where the pound of flesh has been asked from the independent directors. And that concerns me, because as an investor, you don't necessarily—you know, if you want to set the deal with corporate America that independent directors will be held liable for negligence, if that's the deal... you will get directors along the lines you ask for. That may not be good for you as an investor.

One of the things to keep in mind, and I'll finish with Disney, how much time do you think, how many would vote that the Disney board should spend a week on whether to make the "Herbie" movie re-make? Anybody think they need to spend a week?

JOHN OLSON: How about an hour?

LEO STRINE: They spent ten years on the Disney case. Let me give you the short story about Disney. Disney had a bad succession plan. That was true; they didn't have a succession plan. They needed a deal maker. You know who Mike Ovitz was? He was one of the most powerful
dealmakers in Hollywood? Gwyneth used to ride in the back of limos with him. He was making tons of money. His business was worth hundreds of millions of dollars. He is not from the inside. He's not—Joe Bachelder didn't write a report on seventy-fifth percentile of what he should be paid for, even though he's a proven in-house mediocrity; that didn't happen. He's an outside superstar. They brought in a superstar dealmaker to a company that needed him. The outside directors had advice from the CEO and from their counsel. They didn't even have Tower Perrin. They had this rock-throwing guy called Graef Crystal around. Now, if they didn't spend a gazillion years on it, it may be because none of it seemed to indicate any kind of fraud. It seemed to make perfectly intuitive business sense.

It's just like Steinbrenner hiring A-Rod: Now if the Ovitz decision went wrong, it went wrong. But it wasn't material to the firm, and if you think it was material to the firm, then you think the Disney board should spend time on every "Herbie" remake, because it didn't cost them any more than a movie gone bad. So, if you're going to punish people, because every day of your life you know it—when you as students have multiple exams, you have to decide how much time to spend on each.

And the thing about litigation is, Bill Lerach is very good at it. And his job, when he comes into court, is to make the judge and jury forget every other thing that the independent directors had to do and believe that the decision he's attacking was the only issue that was their responsibility to address. The difference between Enron and WorldCom is that they didn't do the most fundamental of their tasks. But the danger is expanding this liability regime; that this focus on the most fundamental of situations will extend to the marginal cases—and that's when you will lose good people. That will not be good for stockholders or society.

LUCIAN BEBCHUK: Bob Monks, do you share Leo's assessment of the Disney case? If you were to decide this case, would you impose liability on the directors?

BOB MONKS*: For once in my life, I'll say something tactful. I am of counsel in the case, and we lost, and we're appealing. So, it would be inappropriate for me to make any comments. I would like to respond a bit to the sense of discouraging good people from being directors. I've been a director of a dozen publicly traded companies and I want to give you just a sense of what actually goes on in board in an effort to help you to understand that with the exception of situations like section 11, you aren't really talking about intelligent people running a risk of personal liability. It's all pretty clear. I was director of a company for nine years, that has

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subsequently become part of the American vocabulary. It has been mentioned several times here today—it's a company called Tyco.

As a director of Tyco, I became very concerned in the late eighties and early nineties with the way in which the board was conducting its business. What do you do if you're a board member and you don't think they're running their business well? It's a hard question, I think because there are lots of sort of club rules about boards. And one of them, at least in boards that I've been on, and other people may have encountered a different phenomenon—is you do not talk about company business outside of the board room with anybody. You don't have directors who meet outside of the board room, because that would be a cabal.

So what I did, what every nice, you know, well-intended graduate of the Harvard Law School does, I sat down and wrote a letter to the chairman of the board. And I collected those, and if you have a masochistic instinct, you can go and buy "Corporate Governance III" by Monks and Minow, for $80.00, and read the collection of letters that I sent to the board over about eight or nine years.

LEO STRINE: $80.00? These are poor law students.

BOB MONKS: Well, we'll do the fourth edition based on this panel.

And, at the end of the day, what really was going on was—it wasn't functioning. People weren't taking responsibility. What was decided wasn't implemented. I was on the compensation committee, and we made a decision and I came back. I found that a bonus that we declined to authorize had been paid.

Well, I finally said, this is pretty ridiculous. Would please, the interested directors please leave the room. They didn't. Now, I'm sitting down—I'm big—so I stood up and I said, "Look is this a matter of whether I can put you out or not" and they all looked at me like I was nuts. You could see that things were getting a little un-collegial.

So, I finally, I had my final magic wand to pull out and I said "All right, I think this board's dysfunctional. We've got to have an evaluation." You know, we have never done anything like that before, so we had an evaluation and guess what? Guess what they concluded? I was a pain in the ass.

So, there by the grace of God, in 1995 I'm kicked off the Tyco board, and I sit and I read in the newspaper five years later that a couple of my colleagues are now residents of one of the more unpleasant institutions in Alan's state. I have no idea what will be the ultimate juridical denouement of my former board colleagues.

But what I'm trying to tell you is, in sort of a lighter vein, look it ain't black magic. You know, I mean it's sort of like—whoever it was defined pornography—you know, if you're decent people, again aside from the
section 11 type of problem, decent people, decently trying to respond to questions, paying attention to what's going on. You're not going to have any problem with being liable. You're just not and there's no reason why decent people can't feel free to serve on boards.

JOHN OLSON: Well, anybody can have a section 11 problem though, because almost every public company issues securities. Nowadays, if the company is a well known seasoned issuer, they can issue securities without the board having more than a few minutes to think about it because you don't have the time to perform due diligence.

WILLIAM LERACH: Yeah, but now wait a minute. Section 11 is implicated only when a corporation is raising new capital from investors, selling securities, pursuant to a registration statement, signed by the directors, put under their nose to sign to get money for their company. In that instance a high standard of liability is entirely appropriate, and it's been a part of unquestioned federal law for sixty years.

JOHN OLSON: That's right.

WILLIAM LERACH: So I hope we're not going to try to erode that, John.

JOHN OLSON: No, no—I wasn't suggesting we repeal it. I'm just saying it's going to be there and directors need to understand that any company that is going to the capital markets is exposing it's directors to potential personal liability.

WILLIAM LERACH: But the company indemnifies them for that. The company indemnifies them for that liability when they're sued.

LEO STRINE: But let's, but let's be practical about this because I think you're right. You're right Bill, but there's a cost to shareholders by not distinguishing between officers and independent directors. A lot of the great director liability cases are really about the directors who were the controlling stockholders or the CEOs. And I think what John is saying, there's not going to be cost because directors are going to insist on a personal asset protection policy, separate from the officers to make sure that they're not exhausted and that is something that people who are capital providers will provide. There does have to be a balance here because it is hard to get caught in that situation where you see what's going to pay for your defense being eroded by the insiders. I think that is what's frightening a lot of directors I talk to.

LUCIAN BEBCHUK: Bob Mendelsohn, as someone who served on boards, what is your reaction to the suggestion that the prospect of personal liability would not deter directors from serving as long as they could easily avoid it by behaving correctly?
BOB MENDELSOHN*: Well, I think that in the real world, it's very difficult to draw a line between what constitutes appropriate and inappropriate levels of director attention to their duties. Although I would agree that Enron and WorldCom are both exceptional fact situations, they are exceptional fact situations that set a precedent. What I think is happening in boardrooms around the world today is that those unusual fact situations have caused significant concerns to directors. An unintended consequence to that has been significant employment for many of the people at this panel who advise those directors how to behave, or who sue them if it's felt they behaved wrongly.

The concern in the real world is that it is not always easy for a conscientious director to know whether he is doing everything he needs to do, or whether a subsequent evaluation of facts will lead to questions, criticisms or lawsuits. Full disclosure: I wear several hats in this debate. I was an insurance company chief executive and we wrote directors' and officers' liability insurance, so I know a little bit about what concerns the people who buy D&O policies. We ourselves were a public company, so we had all of the concerns that a public company has in conducting our business appropriately. Finally, as a UK financial institution, we also were a very major institutional shareholder. So I can wear the shareholder hat, I can wear the CEO hat, or I can wear the insurer hat. Thus I have a fairly comprehensive but perhaps somewhat prejudiced view of what behavior actually happens in boardrooms.

I can tell you two things are happening in boardrooms: Number 1. There is an increasingly risk-averse climate, and we see that not just in the United States but around the world. Let's say directors are confronted with two strategies, one of which is a very, very high risk strategy, but may pay off in a huge way ten years down the road. The other is a very low risk strategy with a safe but low-return probability. There is an increasing bias towards the low risk strategy rather than the high risk but potentially high-reward strategy. Directors now must think about the personal consequences for them if hindsight shows they made a seriously flawed decision (or the rules of the game are different in the future), and it's far easier to do due diligence on the short term, low risk alternative than on the high-risk one. I worry about the impact of that trend both on our global competitiveness and on the long-term health of our economy. Number 2. Demand for directors' and officers' liability policies is way up. Companies are seeking higher dollar limits, as well as separate coverage for outside directors (to avoid the problem referred to earlier where policy limits are

*Former CEO of Royal Sun Insurance Group.
used up in an initial action against inside directors, leaving inadequate coverage for a later action against outside directors). My experience is that companies do not beg insurers to let them pay more money in premiums unless they are worried about something. They are worried that they will lose their current directors, and be unable to recruit quality new ones, unless they can protect those directors against the lawsuits and liabilities we are discussing today. If that coverage is not available, or if it cannot be used because directors are ordered to "dip into their own pockets" then I have no doubt that what those companies are worried about will in fact happen.

When people are asked to go on boards of public companies in the United States, the first question they ask is about the D&O coverage. On the other hand, when people are asked to go on boards of U.K. companies, the first question they ask is about the relationship between the non-executive chairman and the CEO. D&O insurance may be number five or number six on their list of concerns, but it's there. A recent situation in the U.K. where the independent directors of Equitable Life were personally sued has raised the level of awareness quite a bit higher over there, but British directors don't have quite the level of concern that American directors do. Nevertheless I believe the "sue the outside directors" mentality does have a chilling effect on the willingness of people to serve on boards in both countries. I no longer serve on any public company boards, and know many colleagues who feel the same way. The risk/reward relationship is just too far out of balance. Maybe I am not typical: I have seen too many D&O cases, and too much of the toll these lawsuits have taken in terms of time and disruption of directors' lives. But I suspect that I am becoming more typical by the day, and that from a public policy standpoint, the willingness of experienced business people to serve on boards is a real and growing concern.

In conclusion, then, my concern about Enron and WorldCom is not about those two particular cases, which I think we can agree were extraordinary. My concern is about the chilling effect they have, not just on willingness of directors to serve but on what is actually happening in the board room in terms of creating a risk-averse climate and a climate of documenting that homework was done. The amount of non-productive time being spent in audit committees and boardrooms has grown exponentially because people are creating a paper trail to protect their butts. In the long run, that's not good for shareholders and it's not good for the economy, but I don't think you'll find too many directors who will claim it's not happening.

LUCIAN BEBCHUK: Roel Campos, how does the subject look from the perspective of an SEC Commissioner? Are you concerned that SEC
actions that impose monetary penalties on directors could discourage directors from serving? What guides you and your colleagues in addressing these issues?

ROEL CAMPOS*: Well, I think it's fair to say that the SEC has not been a leader in imposing liability on directors per se. You can look at the cases we've brought. In major cases such as Enron and WorldCom, cases that are still under investigation, we often give deference to the criminal authorities, our colleagues at the Department of Justice, before we bring our particular cases. So it wouldn't be appropriate for me to comment specifically about what we might or might not do in some of those cases.

But, essentially—from the SEC's perspective—if you look at the history of cases that the SEC has brought, you will see that in almost every case where we have found liability on the part of directors, there has been a pretty egregious situation. You've had directors who were actively participating in a fraud. The Candie's9 case is an old case that still presents some of the director liability standards. In that case, you essentially had a situation where directors were actively engaged in misconduct, along with the CEO who was also a director, hiding side letters and hiding transactions from the outside accountant.

Recently we had a case called Global Technologies10 in which we imposed liability on the chair of the audit committee. That particular director, who also was a principal with an affiliate of the company, falsified an invoice to Global Technologies—totally created it, and claimed that that revenue recognition was appropriate and failed to disclose that the transaction was a related-party transaction. That allowed the company along with the CEO to essentially capitalize costs that pertained to a separate acquisition. So, I mean, this was again a bad act and a bad actor situation.

Now, I will mention for background, that I dissented in a case involving a mutual fund—it's called Heartland.11 Usually commissioners don't dissent from a settled case that's presented. However, the facts showed that the independent directors came to understand and appreciate that the assets of one of the mutual funds that they oversaw had a mis-pricing and a liquidity problem. They sat back, were very lax, did not

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follow up, and allowed redemptions to occur at the wrong, mis-priced amount—allowing individuals who were lucky enough to redeem early and take their money out at the incorrectly high net asset value. Ultimately, that particular fund had to go into receivership. It had to be taken over by a trustee and eventually distributed funds, but investors who were left only got a fraction of their original investment. Those directors failed in my view to discharge their duties in protecting the assets of the investors and recklessly allowed redemptions at an inflated price, to the damage of other investors.

Now, our Commission held that that action was only negligent and not reckless, and ultimately only imposed a cease and desist order on the particular directors and no other sanctions. I felt that the sanctions should have been more severe. I was one of the five, the only dissenter in that particular case. So, I bring that case to your attention to show that the Commission as a group is very careful with independent directors. We look very carefully at what they do. To date, the SEC has not brought an enforcement action unless independent directors have been involved in very active, fraudulent activities or they totally missed very obvious red flags that were essentially right in their face. I think the SEC historically and even today is going to move aggressively against directors only where there is a clear violation of their fiduciary duties to investors.

That may be good; that may be bad, but that's essentially the view of the SEC. We believe in the business judgment rule, which effects almost all decisions. If there is a good faith business judgment by directors, we think that that is, in the classic sense, a situation in which we will not second-guess the decision, even if the business result is not a good one.

But, again, we are a facts and circumstances agency. Our decisions will depend on the case we have in front of us. From my perspective, I'm only speaking for myself—there are four other commissioners including a chairman. I don't believe that our activities should be frightening directors. If they do their job, if they do their due diligence, and I realize there's a lot of room—in hindsight—to argue about what that is, but if they do their job, I think directors have little to fear from the SEC.

LUCIAN BEBCHUK: Joe Bachelder, in your practice you have represented many executives who served on their boards. Can you perhaps comment on the differences between outside directors and officers? Assuming that personal liability might discourage outside directors from serving, could it still be argued that this concern is much weaker for directors that are also full-time officers of the firm and thus receive substantial monetary compensation?
JOE BACHELDER*: Recently, I had an issue involving a client who was going to be asked to be chairman of the board. This client said he did not want to become the chairman of the board but simply to remain CEO because of the additional responsibilities that might accompany being chairman of the board. I tried to discourage that thinking. He was already a director and the CEO. To add the position of chairman did not substantially enhance his exposure.

When we raise the question of insiders versus outsiders in terms of director liability and the question is whether or not insiders should have a greater responsibility than outsiders—I tend to favor comparability of standards for insiders and outsiders. I think the standards of negligence, and gross negligence, as applied to directors, reflect the part-time nature of their role. It is true that a chief executive officer or a chief financial officer—in the role of officer—is a full-time job. But it is in his or her role as an officer.

One aspect of analyzing "inside" versus "outside" standards is illustrated in the Disney case. The Disney case involved the hiring in 1995 of a new president, Michael Ovitz, a long-time friend and business acquaintance of Michael Eisner (Mr. Ovitz was founder and head of Creative Artists Agency).12

Fourteen months into the employment term, Mr. Ovitz's employment was terminated. Mr. Eisner and Mr. Ovitz met on at least one occasion to discuss the termination, in an apartment in New York City. Like Mr. Ovitz's entrance in 1995, his exit in 1996—at a cost of $140 million—appears to have been orchestrated by Mr. Eisner. (Chancellor Chandler describes Eisner in his role as Chief Executive Officer as "Machiavellian" and as "the emperor of the kingdom of Disney.") One Board member, a long-time legal advisor to Mr. Eisner, was actively involved in the negotiation of the contract with Mr. Ovitz but the other members of the Board generally had an inactive role.

The Delaware Court of Chancery, in the August Disney decision, gives us a picture of how a Delaware court approaches director responsibility, whether the director is an outsider or an insider. As to all directors—this includes Mr. Eisner and Mr. Ovitz—the court applied the

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12As an aside, I would note that a one-hour meeting of the Disney Compensation Committee took place in September of 1995 to approve the employment arrangements making Michael Ovitz President of Disney. It has taken the courts of Delaware ten years in the litigation of a case to decide issues arising out of that one-hour meeting. The latest decision, by the court of chancery in August 2005, is subject to appeal to the Supreme Court of Delaware, which would render the sixth decision in this case. That one hour has cost a lot in terms of time and expenses reviewing it in the Delaware courts.
same good faith standard. The court states that a director will be found in
bad faith if he engages in a reckless disregard of his or her responsibilities.
The court found no director to have violated his or her fiduciary duties.

It seems to me that the inside directors of our major public
 corporations are not subject to a higher standard than outside directors—at
least not one that is clearly defined. Instead, the test of whether a director
has met his or her duties as a director will be based on all the facts and
circumstances of the particular case. What may seem reckless in one set of
circumstances may not be in another. What may be appropriate as to one
director may not be as to another. There is no clear, bright line here
between inside and outside directors, at least based on Delaware decisions.

WILLIAM LERACH: I'll tell you one thing. The Enron shareholders
sure wish that board had been a little more risk averse. Now wait a minute
here. I want you to listen to what's being said. In this country, doctors,
lawyers, accountants, surveyors, and weighers are all required to use due
care in the exercise of their work every day to protect the people they might
otherwise harm. And yet, you're hearing it argued here that corporate
directors, educated people with unlimited access to professional assistance,
can act negligently so long as they don't stuff money in their pockets from
the transaction. Now, that is the standard of care that is being urged for
people who control the most powerful institutions in your society. Think
about the consequences of that, because ordinary people wouldn't tolerate
it.

JOHN OLSON: Take it to the Yale Drama School. This is the
Harvard Law School. Let's go.

WILLIAM LERACH: And that's part of the problem. And that's just
what corporate America wants is this kind of antiseptic debate that really
pretends there are two reasonable sides to these issues while public
companies are pilfered and robbed by insiders who disobey their
obligations.

JOSEPH BACHELDER: I think the standard that we're speaking of
is that which under Delaware law is essentially gross negligence. There
will be scandals from time to time and yet we need to provide an
atmosphere in which directors can function. We are a society that has
murders, but we are not a society of murderers. The fact that we have some
scandals doesn't mean that CEOs generally are prone in that direction, nor
is senior management, nor are outside directors.

LUCIAN BEBCHUK: Byron Georgiou, in your practice you work
a lot with institutional investors. Would you advise institutions to seek
monetary payments from directors in future cases?
BYRON GEORGIOU*: Well, I think increasingly you find that, since the passage of the 1995 so-called Private Securities Litigation Reform Act, one of the unintended consequences was that it empowered institutional investors. The law previously provided that the first party to the courthouse became the lead plaintiff, even if they only had a hundred shares. The 1995 statute provides that the party that suffered the largest financial loss will be the presumptive lead plaintiff. So what that has done is move these cases in the direction of lead plaintiffs being large institutional holders, like Mr. Hevesi’s New York Common Fund, CalPERS, CalSTRS, and others that we represent.

These large institutional investors are taking a very serious leadership role, insisting upon personal director liability in certain instances, incentivizing plaintiffs’ lawyers like ourselves by suggesting to us that they would agree to a certain percentage fee to us of every dollar that we recover, and a higher percentage of every dollar that we recover personally from directors, or from insiders, not necessarily directors, who sold stock at inflated prices during the period of the fraud.

To turn to your question Lucian, there are many reasons we ended up where we did in Enron, with regard to the directors. Although I too graduated from this ivory tower institution some thirty years ago, in the real world, you have to deal with the circumstances presented. In Enron, they had a $350 million directors’ and officers’ liability policy.

At the first settlement conference that we were directed by the court to attend, six of us signed in for the plaintiff’s side and 276 lawyers signed in for the defense side. So, while we were working on behalf of the class of defrauded investors, defendants’ lawyers were billing $10 million a month of the directors and officers liability insurance policy in defending these cases.

So, at some point along the way, after defendants had frittered away $150 million of the policy, we decided we ought to save some of that insurance money for the victims of the fraud rather than just the lawyers and experts who were representing the defendants. As a consequence, we put a stop to the bleeding: We settled for the remaining $200 million of directors’ and officers’ liability insurance which had to be shared both with Enron itself, which claims to be a victim of its own perpetrated fraud, and the criminal and civil defendants who still had to continue to defend themselves.

At the end of the day, we got $168 million of the original $350 million dollar D&O policy for the defrauded investors. At the same time,

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we got an additional $13 million in personal contributions from the
directors, ten percent of their pre-tax insider trading proceeds. Now we
could have held out for more from the directors, but had we done so, during
each month that we held out, the D&O policy of $350 million would have
been further depleted to the tune of close to $10 million.

So we made a calculated judgment that it made sense to settle the
case with the outside directors, notwithstanding the fact that in The New
York Times, Professor Bebchuk wrote an editorial piece criticizing us for
not having taken enough of the Enron directors' personal money in the
settlement. The same day that The New York Times piece from Professor
Bebchuk appeared, the Wall Street Journal editorialized that we were the
scum of the earth for having taken even one penny of personal money of
directors. So, we keep these two editorials side by side on our wall—indicating that we probably reached a pretty good accommodation
regarding personal liability of the outside directors.

Never forget that the Enron board was literally asleep at the switch.
The chair of the audit committee, a former professor of accounting and
former Dean of the Graduate School of Business at Stanford University,
chaired the audit committee for many years. It included three other people:
Wendy Gramm, who lived in Texas, wife of Senator Phil Gramm, a friend
of Ken Lay, Enron's Chairman.

JOHN OLSON: She's also the former chair of the . . .
BYRON GEORGIOU: Commodity Futures Trading Commission.
JOHN OLSON: And had a Ph.D. in Economics.
BYRON GEORGIOU: Indeed. Ok, as is the case for the chair of the
Audit Committee. The Audit Committee also included an English Lord,
whose name escapes me, and a businessman who lived in Hong Kong.
Now, because the earth rotates on its axis, no matter what time of day the
Audit Committee met by conference call, somebody had to be asleep, at
least one, maybe more than one of the four of them, had to be asleep during
the meeting. During this period, the Enron Audit Committee met almost
exclusively by conference call, not in person.

So how much auditing did they really do? How much did they
exercise their supervisory authority? Three times in the course of one year,
the board waived the conflict of interest rules of Enron corporation to
permit their chief financial officer, Andy Fastow, to be the general partner
of the LJM2 partnership which engaged in a whole variety of off-balance-

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sheet transactions with Enron, in which he made $35 million, and negotiated as the supposed counter party to Enron on behalf of the entities that LJM2 funded. He was on both sides of the transaction, lining his own pocket and permitting these entities to be created, the sole purpose of which was to purchase Enron assets near the end of a quarter so that Enron could inflate their revenues and earnings and represent that they had met their earnings targets. So, this was a board that affirmatively assisted in the fraud and deserved to be held personally liable.

Now, I would juxtapose that, with my own experience, as chair of the audit committee of a public company traded on NASDAQ, engaged in the mail-order pharmaceutical business. For a whole variety of reasons, not attributable to fraud, the company went bankrupt after ten years, squeezed between the large pharmaceutical companies and the payers of health care services.

We got sued; the case settled for a modest amount of insurance coverage, without director personal liability, because we proved that we had worked hard and done our jobs as fiduciaries.

Personal liability will be extracted from outside directors, or even insiders, very infrequently; in particularly egregious circumstances. In the cases that we handle, thanks to the good work of Bob Monks and LENS Governance Advisors, we seek corporate governance improvements in addition to the money we secure on behalf of fraud victims. And in many cases we have obtained the right to appoint, on behalf of shareholders—new directors. Bob and his firm are able to find many people in this society who are prepared and very well-qualified to serve as corporate directors.

To the students here, I would remind you that you never know what you're going to end up doing. I graduated from this school thirty-one years ago. When I entered in the fall of '71, there were fewer than ten percent women, and I managed to graduate without ever having taken Corporations, Securities Regulation, Commercial Transactions, or Antitrust. I focused on practical lawyering, working with Gary Bellow, founder of the clinical program at Harvard, the Cambridge-Somerville legal services office for civil litigants, serving in the Lowell public defender's office, and in a constitutional litigation workshop with Charlie Nesson. Most of my career hasn't had a lot to do with those areas of the law and now I find myself a lawyer for the class of defrauded investors in the Enron case doing securities litigation, a subject about which I knew very little until less than ten years ago. So, study hard, enjoy yourself and your career will develop.

LUCIAN BEBCHUK: John Wilcox, Byron mentioned fee arrangements that provide counsel in class action cases a larger percentage
of the recovery from directors themselves than from D&O insurers. What is your view of such arrangements?

JOHN WILCOX*: Well, hello everybody. I feel like the caboose at the end of a very long freight train.

Let me first say that this: what we are talking about here is really a loser's game, because by the time we get into these issues the damage has been done, the shareholders have lost lots and lots of money, employees have lost their jobs, and you've heard the whole litany of things that happened to destroy shareholder value.

The question we are addressing really looks at two aspects of director liability: One, is it the proper punishment? I'm not wildly interested in that question. I'm more interested in the second question, which is whether liability can function as a preventive for future situations.

In other words, will fear of liability strengthen directors' independence? Will they be more willing to stand up to an overreaching chief executive officer? Will they be willing to ask for more information when it's not clear exactly what's going on at the company? Is fear something that will drive directors to perform more diligently, or is fear going to be so great that they will be completely risk-averse, as you've heard earlier?

I don't really know the answers, but at this point I feel as if it's very healthy for these questions to be asked. And the scandals we have seen in recent years are very, very extreme. These are not very difficult situations to make judgments about directors' failures or performance and failure to ask questions. The questions particularly in the case of Enron, extend not only to the board of directors but to every other gate keeper, every other player, starting with the investment bankers and financial advisors and the auditors and the employees and the institutional investors for that matter.

JOHN OLSON: And the lawyers . . .

JOHN WILCOX: And the lawyers, of course. There were plenty of institutional investors who were putting money into these off-balance sheet partnerships that Andrew Fastow was creating. One very large institutional investor admitted very soon after the Enron debacle was exposed, that they had been advised by their legal counsel that some of these partnerships were flawed and that they ought not to invest in them. But they failed to take that information to anybody, much less to the board of directors of Enron, and they failed to take it to their equity investments side which owned millions of shares of Enron.

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*Senior Vice President and Head of Corporate Governance, TIAA-CREF.
JOHN OLSON: But, they did pull out of the investment, but didn't tell anybody else. That was CalPers, right?

JOHN WILCOX: Correct. And so this is a case of collective guilt. Have we all learned something from it? Of course. The more difficult question is how long will we remember this lesson and will it still be remembered when the next opportunity arises to make short-term gains? These are large questions, but I think from the viewpoint of shareholders, the more important issue is: Do we need more incentive for directors to ask harder questions—and to not be so accepting of information that comes from management that may not fully answer those questions? The same question could be asked of the analyst, the securities analyst on Wall Street, who didn't understand how Enron was making money, but didn't ask the question: shouldn't I, as an analyst, if I'm recommending that my clients put their money into this stock, shouldn't I understand how Enron makes money? They didn't ask that question.

We've been through a learning experience just like the bubble market in a sense. Frankly, I feel that once you've had these kind of experiences, the bar has to be set higher. When very extreme situations arise we have to set tougher standards for directors. We can't simply go back to the existing standards and say well, we had an Enron under these standards, but gee, they're still good standards anyway. I really don't think we can say that. We have to go to higher standards.

Now, the question that you asked me, Lucian, was whether or not TIAA-CREF should act as a lead plaintiff. TIAA-CREF, whom I am not speaking for officially at this point, has not been a lead plaintiff in these cases, and that's in part because our emphasis has been on trying to take preventive action, as I was describing earlier. We want to devote our resources more to value creation, rather than to punishment or picking up the crumbs that remain after someone else has made a mess.

So, our emphasis has been on trying to engage in dialogue with companies that we spot in our portfolios who are not performing well, who have bad policies, who have egregious practices that are in violation of our policies and standards. Our hope is that we will be able to help cure some of the problems before they get to a point where to the matter is in court and all that is left is to try and pick up the crumbs. As I said before, prevention is better than punishment.

TOBY MYERSON: I think the Enron and WorldCom situations are examples of bad cases making bad law. The fact patterns in those cases are sufficiently egregious that Bill's righteous indignation is completely understandable. But the fact is, life is not that simple. It's not enough to say that, if you're a good, hard-working, law-abiding citizen, you won't have a problem. Corporate life and the decisions corporations have to make and
do make on a daily basis are not easy. And I'll say to Robert Monks, who's sitting next to me, there are not many directors who have his investment experience and acuity to perform the job the way he does.

So, for example, I had breakfast a while ago with the outgoing chairman of the audit committee of one of the largest and most well respected companies in America. That audit committee chairman said, "You know we worked hard and we had lots of meetings. We devoted a lot of attention to all the things that our audit committee should be doing." "But, I'll tell you," said this director, "if management wanted to pull the wool over our eyes, we would have had no clue." And so you ask yourself if you're on the board of a large financial services company, how much do you need to know about hedging? How much do you need to know about derivatives? How much do you need to know about financial market strategy? That's way beyond the capability of the ordinary intelligent person. If you're on the board of a pharmaceutical company, how much science do you know? Do you need to know about the risks associated with bringing a new product to market? And so to say "if you do your job, you won't have problem," is just not "real-world" in my experience.

I get questions all the time from people thinking about going on boards of directors. After giving the normal sermon about what the law provides, the questioners will say, "Well I understand all that, but what do you really think?" Most people who consider acting as directors don't want to have their name in the caption of the lawsuit. They don't want to have to establish that they didn't do anything wrong. They don't want to have to be deposed and spend their time dealing with the litigation. Life is too short. People are busy; they have other things to do.

So, the fear that was created following WorldCom and Enron really is not positive. But I'm an optimist, incurably so, and I believe the pendulum is going to swing back in the right direction. And I think Vice Chancellor Strine said it extremely well in his remarks about the Disney case. People were focused on that case because directors were being sued for $140 million personally, and the Delaware courts got it right. The hiring and firing of a superstar CEO, paying him at Disney what he had been paid before he went to Disney is not such a big deal. And while $140 million is a lot of money to pay on an exit, in the scheme of things it's not as much money as Disney spends on some movies.

The issue in Disney was whether the directors did enough work on the matter and paid enough attention. They weren't perfect. They made mistakes. But I think the court got it right. So I think the real question here is whether we have created an environment where good men and women, who'd like to serve on boards will feel uncomfortable doing so. The
question comes up every day. For the future, I'm hopeful there are going to be more Disney cases which essentially will set the balance a little better.

JOHN WILCOX: I'd like to make a comment about the Disney case. There is some language in the opening part of the case in which Chancellor Chandler talks about the basic issues. And the language in effect says, that when there has been a failure of the company and the board of directors, a business failure as opposed to a failure of fiduciary duty, the solution should be left to the markets and to shareholders, not to the courts. And I read the case, I think it was correctly decided for the reasons that have been discussed here. But I read that case as sending a very strong message to shareholders—that it is there responsibility to make clear to directors and to companies what their expectations are. The court in that case says that the directors could not be held liable for failure to meet aspirational best practices in the area of executive comp. And so what I take from the case is that it is the responsibility of shareholders but also of regulators to make actual what is currently aspirational, so that it will not longer be possible for boards of directors to say, "Well, gee we didn't really know," or "That was really only an aspirational standard, and we did the minimum and we met the legal requirements." That's not the kind of behavior that we want in the boardroom.

So, I think this is the way the process works. This is the way it's been working for the past twenty years, since we've had an active governance campaign lead by institutional shareholders such as TIAA-CREF and Calpers and others. We all have different styles in the way we approach this. But this approach makes, is quite effective in changing the standards within and the behavior within the boardroom and it's a positive approach. It's also less costly than going to court. Although, sometimes it is rather slow.

JOSEPH BACHELDER: I'd like to mention again something I said earlier today. I think that time and staff is a problem for directors and we have to realize how little time, relatively speaking, is spent by directors on the business of the corporation that they oversee. Think of yourselves here. Compare the proportion of time that the directors spend, let's assume a couple hundred hours a year, with the ten times to fifteen times that number of hours that a CEO and the senior management spend on a corporation's business. Suppose that you were taking this course and you spent 1/10 the time on it that you are spending.

This is the dilemma, in part, for corporate governance in this country because boards of directors not only do not have the time to compete with a full-time management in terms of time, but in addition, they don't have the staff. Consider the staff that would have been available to the executives at Disney in respect of research and getting into the process of
succession and compensation. And what did the committee have? They had one compensation expert who spent fifty-seven hours, I believe, on the matter. I think, in this situation, part of the solution is to address better staffing of committees and probably increasing the budget of time spent, especially by those who are the chairs of committees.

BYRON GEORGIOU: Part of the problem is the determination is made by the directors themselves. We have directors in this country who still serve on five and six boards. It's preposterous, inconceivable. You can't possibly do it. I personally was offered a directorship of a NYSE company, which I declined because I'm too busy right now. We have one more year before trial in the Enron case. I cannot afford two days a month to participate in a board meeting and serve on the audit committee. So I felt that I could not handle even one directorship given my more than full-time day job. How it is that other people believe that they can handle two, three, four, five, six directorships, while also holding full-time jobs, is completely beyond me.

JOHN OLSON: Byron, I think that's a very good point but think about it a moment: if you're right, who will end up serving on boards? You don't have time for even one, because you're a full-time practicing lawyer, and I must . . . I agree with you. I'd never agree to serve on a board and after I retire I don't know whether I would. I'd have to look at the board and . . . I think it does take time. So you're talking about boards that will be staffed entirely by folks who do not have other full-time employment. CEOs are not joining many boards now, and more and more, companies are saying to their CEOs—we're not going to go let you serve on somebody else's board because it takes too much time. And we don't want the risk that our reputation might get tarnished if something goes wrong at that other company. So you can't get sitting CEOs; you can't get people that are full-time most anything, except perhaps academics who have more time flexibility than most.

BYRON GEORGIOU: If you can call those full-time jobs. (audience laughter)

JOHN OLSON: Yes, having been a full-time academic for a short time, I can tell you it's harder than I thought it was going to be. In any event, there's an issue there of how much can we reasonably expect directors to do? And if we're going to expect a great deal, are we going to be happy with boards that are made up entirely of retired corporate and government officials and academics? Are those going to be good monitors?

There were a lot of those kinds of people on the Enron and WorldCom boards and they, at least in that environment, as Bill so ably pointed out, were apparently very poor monitors. And it wasn't because they weren't available.
BOB MENDELSOHN*: I'd just like to make a couple of comments. As a former chief executive, I'd like to talk a little bit about what I wanted from my independent directors, because that will give you a sense of the skill set that is required. I do have a lot of concern about the ability to recruit people with that skill set in the future. First, let me say that there is no way that any independent director will be able, in the face of a concerted and well-planned management fraud, to figure it out. I'll make that statement with little fear of contradiction. No matter how conscientious, a director cannot possibly know as much about the business as the management, and without an unusually deep knowledge of the industry in question, probably will not see the warning flags if indeed there are any.

So their main focus should be on insuring the integrity and competence of management. That's pretty much the main function of a board of directors. You have to make sure that the internal controls in the company are effective, and the people who are operating those internal controls are people of integrity. Now, sometimes you're going to get one of those wrong.

But, basically, the most important job of an independent director is monitoring things that we haven't yet talked about today—the ethics, the morality of the company as it is actually conducting its business, because that's the greatest safeguard for the shareholders. I wanted independent directors who would ask me questions, who would make me think about things that my staff didn't make me think about, because in any organization, stuff gets filtered as it goes up the line towards decision makers. At every stage of the process, well-intentioned people slightly slant the facts. By the time information reaches the decision maker, it may not be accurate. We even see that in government!

What you want is a board of directors who will sit in the room and ask questions about whether this proposal or that action really makes sense. Does it conform with common sense? If I were running this business, would this feel right to me? That's what I was looking for: people who came from different backgrounds than our professional staff who would be willing to challenge and ask questions. That's the most valuable independent director. That's also, as John Olson says, the hardest one to find. Because there's a huge time commitment to being a director, and in today's world it's an uncertain time commitment.

As Byron Georgiou I'm sure will tell you from his experience at the company he mentioned, when your company gets in trouble then all of a sudden the directors have a new full-time job. And the amount of time that

*Former CEO, Royal and Sun Alliance Insurance Group.
they have to spend going through their own paper trail to prove that they were not asleep at the switch and that, on that international conference call which we referred to earlier, they actually were awake in the middle of the night is significant. Incidentally, we did those calls in an interesting way; we did videoconferences and put a little video camera on top of everybody's home computer around the world, so we could actually see if anyone was nodding off!

But in today's world, where your company is going to be run from multiple time zones decision-making via video or voice conference call is the way it actually happens because you can't physically get people from Asia, Europe, the Middle East, Africa, North and South America all together at the same time. It just doesn't happen.

So, independent directors must have both a willingness to ask questions and a willingness to devote a substantial amount of time to the business of the company. Therefore you cannot sit on six boards, public boards. And you have to be willing to take the risk that you will make a wrong decision and that a business transaction that you thought was perfectly legal at the time will, in hindsight, be looked at as something different. Then you're going to have to spend immense amounts of your personal time defending yourself and your business decision. That's the environment that we're asking our independent directors to come and serve in. It is increasingly a tough sell. I think that's the bottom line I take out of this panel today. In today's climate, recruiting a high-quality independent director is a tough sell. People are not banging down the doors to become chairmen of audit committees of major public companies and I don't think they're going to be banging down the door for several more years.

WILLIAM LERACH: Well, I'll try not to be too intemperate. Look, the 15,000 US public corporations are the most powerful economic vehicles in our free market economy. They have a virtually unlimited capability to do good or inflict harm. Corporate boards, people are highly compensated, paid hundreds of thousands of dollars a year, in many instances, control the action of those corporations. John Wilcox really was right when he said the key here is not cleaning up after the mess. We can always have a lawsuit; we can always sweep up. The real key is can we find a way without diminishing entrepreneurship and risk-taking to improve the level of behavior in the corporate boardroom to benefit us all.

I think today, honestly, John Olson will know this more than anyone, I think boards, whether they are frightened of us and lawsuits or are reacting to Sarbanes-Oxley, or a combination of both, are more activist. You saw in the paper the other day the board threw out the CEO and CFO at Mercury Interactive for tinkering with the stock option pricing. That wouldn't have happened ten years ago. That would have been covered up
and those guys would have continued to run the company. That's just one example. Boards are becoming more assertive and that's good, but it's a constant struggle and we just have to try to find a way through a whole combination of circumstances—federal regulatory efforts, good judging like Judge Strine if he was hearing our lawsuits—just to keep the pressure on these people and get them to do a good job. Their jobs are too important for them not to do them well.

LUCIAN BEBCHUK: Let me now invite students to ask some questions. When asking questions please indicate the panelist to whom the question is addressed.

STUDENT: I'd like to ask Mr. Lerach. It seems easy to look at it from hindsight to see certain behavior as inappropriate—it's harder to sort of put yourself in their shoes when the decision was being made. I'm wondering if in these times when corporations are becoming larger and their operations are becoming more complex, just because it's more difficult to make that determination—that's one of the reasons why the standard's being raised? And two, I don't know how significant this is but, is there any sympathy for these people who unfortunately have to go through difficult times during, when the doctoring is evolving right now?

WILLIAM LERACH: You know, in the real world there is no sight but hindsight. That's the way all of our judgments get tested. It's looking back on what happened and that's why we all try to do a good job when we make decisions. That's just the way the world operates and I do think that directors got caught in a vortex of applying contemporary standards to legacy conduct that happens also in society when something changes. But I said, I really believe, I think boards through good counseling from their counsel, regulatory pressure, the threats of lawsuits—I think they're doing a better job. Directors are doing better.

JOHN WILCOX: If I could just add to your comment which is that, your's is a very, very good question, but I think it should be asked a bit more broadly. It should be asked about others who are involved in this situation not just the board of directors. And in the case of Enron, particularly, we see a failure on so many levels. We go through the whole laundry list of people who are supposed to be gatekeepers, who are supposed to be making sure that the ultimate shareholders interests are protected including the Securities Exchange Commission, the New York Stock Exchange, everybody else—all the regulators as well as the auditors and those who are actively involved with the company. They all failed and your question is an excellent one to apply to those players as well. What were they thinking about at the time? Why did they fail? It's very clear from hindsight that they, in fact, failed. Securities analysts failed as we discussed. Why did they fail? And how can we prevent that from
happening? These are, that's why we're here. That's why we're having this
class. That's the kind of question that we want all the players to be asking
themselves as they move forward.

JOHN OLSON: As a graduate of this law school, somebody who's
also taught in other law schools, I really do think we need to again ask, as
you did a moment ago, John Wilcox, the question that Stan Sporkin, as a
judge, asked so many years ago with the failure of a major financial
institution: where were the lawyers? In Enron, one law firm has already
paid a settlement, another one is still a defendant. Every one of these
transactions in Enron was documented by lawyers, some of them reporting
directly to Mr. Fastow who brought in as his personal lawyers to do these
questionable deals.

JOHN WILCOX: Couldn't have happened without the lawyers . . . .

JOHN OLSON: It could have not have happened without the
lawyers. And the lawyers and others—bankers have already paid billions,
and may pay more—had to understand that these deals had a highly
questionable business purpose.

If you haven't read Kurt Eichenwald's book, "Conspiracy of Fools," it is the best book that I have read in ten years on the anatomy of what can
go wrong in a business. It's the story of Enron from lots of different
perspectives, extremely well reported and very, very interesting. I really
highly recommend it. If you've read that book, you will understand why
John Wilcox is saying, where are all these other people? And I do agree
with Bill, directors are much more concerned, more conscientious. I'm glad
we're over the first phase of Sarbanes-Oxley because I think we spent
totally too much time on process. Directors are now asking the hard
questions and I think that's good.

BYRON GEORGIOU: Kurt Eichenwald's book on Enron is the best.
For those of you students at the Harvard Law School who prefer cinema to
reading, I suggest "Enron: The Movie," which was based on another book,
"The Smartest Guys in the Room"; providing a sense of the culture of
Enron. See it before January, when the criminal trials begin against Lay
and Skilling. Our civil trial isn't scheduled until October.

Remember the auditors. Andersen essentially lost a 150 or 200-year-
old franchise over what happened at Enron. They were making $52 million
a year auditing Enron, the second largest fee producer for the Arthur
Andersen firm, the "million dollar a week" club. When an auditor receives
a million dollars every week from a company it is auditing, the money
blunts the willingness to stand up and be counted, confront the CEO and
CFO, and tell them their accounting is fraudulent.

Of that money, twenty-five million was for audit services and
twenty-seven million was for so-called other services—consulting
primarily. In the AOL-Time-Warner merger, Ernst & Young was the auditor for AOL, the auditor for Time-Warner, the auditor of the merged company AOL-Time-Warner, and, because AOL was such a young company that didn't have any internal controls, Ernst & Young created, for a fee, the internal controls at AOL, which they then audited as AOL's auditors. They also made the recommendations to the boards of both companies that this was a fair merger, which turned out to be the worst corporate merger in history.

People are tempted to commit fraud or to engage in inappropriate conduct where their bread is buttered. The rating agencies—Standard and Pours, Fitch, and Moody—all rated WorldCom's bonds issued in May of 2001 as investment grade, the largest bond issue in history—12.1 billion dollars—and they did so even though the accounting was completely changed between 2000 and 2001 at WorldCom. In 2000, they had expensed the routine and customary line maintenance expenses of their telecommunication company. In 2001, they switched and decided to capitalize those costs. As a consequence, with essentially the same top-line revenues during calendar '99 and calendar 2000, WorldCom reported demonstratively greater profitability because they reduced their expenses by hundreds of millions of dollars. Now, shouldn't somebody have caught that? Shouldn't the auditor who wrote the audit opinion on those financials, shouldn't the rating agencies have caught it? . . . But all of them were getting a piece of the deal. The investment bankers got a percentage of the deal when they sold the bonds. The rating agencies got a percentage of the deal . . . for rating the deal. The lawyers got a big fee. The underwriters got a big fee. Everybody got a big fee. You must look carefully at the economic incentives to evaluate the bona fides of the deal.

JOHN OLSON: Directors don't get a big fee though.

BYRON GEORGIOU: No they don't. Look, I served as a director and you're right. When our company went under, the chairman and CEO resigned. I took over the chairmanship for the whole company. I spent essentially half my time for no money, because we didn't even have money to pay our puny directors' fees, but I considered that my obligation. If you're not prepared to do it, you ought not to accept it. Good people will serve as directors. There is still a certain degree of prestige in serving on the board of directors of these companies and I think people will continue to do so.

TOBY MYERSON: Byron just help us out here. I am not aware that Arthur Andersen was ever found liable for fraudulent accounting by a court decision. Arthur Andersen was put out of business by a finding of obstruction of justice for destroying documents, something that was a highly questioned decision as a matter of government enforcement policy.
JOHN OLSON: That was reversed by the Supreme Court . . . but too late to save the company.

TOBY MYERSON: Thank you, John, because that's an extremely important point. Not only was it a criticized decision as a matter of enforcement policy, but the United States Supreme Court reversed the decision. Of course, the patient is already dead. Your suggestion was that Arthur Andersen had been found to have been responsible for fraudulent accounting and I don't think that decision's been made yet.

BYRON GEORGIOU: That decision hasn't been made and, of course, they're entitled to a trial in October of next year if they don't settle beforehand, which I expect they probably will. The Supreme Court, in a 9 to 0 decision, reversed the criminal conviction of the firm on the ground that the scienter instruction to the jury was inappropriate, and that's an entirely different standard from the standard of proof in the civil case. Arthur Andersen's own internal, professional, centralized entity back in Chicago, where they were headquartered, had many meetings in which they questioned—the propriety of the accounting of these transactions at Enron for at least two years prior to the blow up of Enron and, notwithstanding that, Andersen didn't come forward with any qualification of their audit opinions. Now we'll see whether they're found liable or not. David Duncan, the head of the Houston office, the principal person at Enron, was the largest fee producer for Andersen. A lot of sins will be ignored in a professional firm on behalf of a person who brings that kind of money to the firm.

TOBY MYERSON: The only point I was trying to illustrate is that none of these allegations have been decided by any court.

BYRON GEORGIOU: Indeed, that's true. But they did shred the documents . . . (audience laughter). They shredded so many of them that they had to get extra trash trucks to pick up the confetti at their headquarters in Houston. We found out about it because one of the janitors, who happened to be a beneficiary of the Enron retirement plan—prevented from selling his 401K stock while Lay was selling his—saw these huge boxes of shredded documents. He brought it to our attention and we turned it over to the FBI. The FBI investigated, I leave it at that.

JOSEPH BACHELDER: Just a quick point. How many boards of major U.S. corporations have a corporate governance audit at the end of the year in which an independent outside counsel comes in and sits down with the board to review issues that have come up during the year and to advise the board on its thinking as to those issues?

JOHN OLSON: I don't know about every year, but there are a fair number of companies now, through their board nominating and governance
committee, that are doing what they call benchmarking or a corporate governance audit and there are even some law firms out selling the service on a fixed fee. I don't know what the percentage... do you have any sense, John Wilcox? I think it's certainly a minority, but it's not an insignificant number.

JOHN WILCOX: Well, it's done in many different ways and it's often tied in with the mandatory training that is now required of the boards. And I think that's probably a very useful exercise if they treat as something other than just doing what is required.

JOHN OLSON: I mean in the last couple months I've participated in training sessions for directors of five major companies and that's just me. And so, I think there are a lot of companies that are doing something to be sure that they are using state-of-the-art, best practices in their governance.

LUCIAN BEBCHUK: So on this optimistic note, let us close our panel for today.