

Outside Directors at Risk: How to Serve and Protect Yourself

By Seth I. Rubin

In early 2005, outside directors of WorldCom and Enron agreed to litigation settlements that required these directors to make payments to plaintiffs from the directors' personal assets. In the aggregate, these payments totaled nearly \$40 million and signaled that outside directors were no longer safe from the courts. In the wake of these outcomes, and the SEC's continuing focus on holding outside directors responsible for failing to detect management wrongdoing, many outside directors have become understandably concerned that their personal assets may be at stake based on what they did – or failed to do – in the boardroom. In particular, those outside directors who sit on audit and compensation committees may find themselves (and their personal assets) at considerable risk and rightly wonder whether it is worth it.

In light of the scandals, and the ensuing growth of the corporate governance infrastructure at the SEC, outside directors now must be zealous about availing themselves of all available tools of protection. While there is no bulletproof methodology to avoiding liability (other than refusing to serve), careful adherence to accepted, well-established "best practices" can provide directors with some comfort and, ultimately, protection from liability. So, what affirmative steps can prospective directors take to protect themselves?

For starters, before accepting a position as an outside director, a certain amount of due diligence on the company offering the board seat is strongly advised. Prospective directors will want to confirm that a company's charter contains a provision eliminating to the fullest legal extent directors' liability; the existence of an internal audit staff; the membership of other experienced and well-qualified outside directors and general counsel; and that the company has implemented a code of conduct that complies with applicable regulatory requirements. In addition, directors should have written indemnification agreements affording them full legal protection, as well as appropriate levels of D&O coverage and additional coverage to provide

protection when coverage has been denied or insurance has been depleted. Directors may also want to review who a company's investors are. If large institutional investors with a penchant for lawsuits are among the major stockholders, a prospective director may want to think long and hard before signing up for the position.

Once they've accepted their positions, outside directors must be more engaged in company activities, require more information when necessary, and make certain that appropriate controls are in place to ensure that the board of directors is attuned to problems before they develop into scandal. Steps that outside directors should be taking include:

- Increase the frequency and number of board and committee meetings and spend the time necessary to understand information provided to the board
- Hold meetings with key employees other than the CEO and CFO, and meet periodically with the company's general counsel, outside counsel and auditors
- Ensure that the requirements of the Sarbanes-Oxley Act have been implemented, including internal financial controls, audit committee requirements and whistleblower protections
- Maintain records to demonstrate careful deliberation of potential red-flag issues; directors must act promptly and decisively when faced with potential problems, particularly regarding a company's financial statements or internal controls
- Carefully review executive compensation and all transactions with officers or directors that raise conflict of interest issues
- Insist that serious issues and problems are discussed thoroughly and appropriate solutions are designed; be sure to involve counsel early in the process, where necessary, and be sure to document all responses
- Make certain the company has a chief compliance officer with real power to handle major problems

Directors also need to make sure that companies develop and maintain an effective corporate compliance program. Such a program should be run by a compliance officer who is independent of management and reports directly to a committee of the board of directors. Essential pieces of a compliance program include:

- Full support of senior management, in word and deed
- Educational programs for all employees – not just newly hired employees
- A system whereby concerns about corporate conduct can be made (e.g., ethics hotline), combined with a clear policy of non-retaliation for honest reporting of improper corporate conduct
- A committee or compliance officer who will evaluate complaints and take appropriate action, and who will have the ability to conduct a full and impartial investigation of any complaints
- Periodic reporting to the board as to the effectiveness of the compliance program
- Maintaining the compliance program's integrity by reporting the results to the complainant

Effectiveness is an essential component of a company's corporate governance and compliance program and is also necessary for the protection of directors. For example, if a board member sees that, after a lengthy period of time, there have been zero complaints to the company's ethics hotline, affirmative steps need to be taken to ascertain whether the hotline is effective; if it is not effective, directors should encourage the company to take appropriate steps to improve it. Being proactive is the key to liability avoidance, as the failure to take action may create the next wave in the broadening trend to seek to hold directors personally responsible.

In the coming years, scrutiny of outside directors will continue to intensify. To avoid such scrutiny, or to maximize protection of their personal assets in the face of an investigation, outside directors are strongly advised to follow the steps outlined in this article to demonstrate how they met their duties to the company and its stockholders. Without taking such steps, outside directors are not only failing the company's stockholders, they are failing themselves.

Seth I. Rubin, Esq. is a partner and member of Ruskin Moscou Faltischek's Corporate and Securities Department. He can be reached at (516) 663-6691 or srubin@rmfpc.com.