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Why Directors Pay - The Latest Wrinkle in the Corporate Governance Movement

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Summary

From a corporate governance viewpoint, 2005 began with a bang when former directors of Enron and WorldCom agreed in the first week of January to dip into their own pockets to settle shareholder suits alleging that their failure to perform their duties as directors contributed to the two biggest corporate frauds of our time. Just as in 2002, when the collapse of Enron and WorldCom, with their combined loss of approximately $230 billion in investor money, kicked the corporate governance movement into high gear and led to the passage of the Sarbanes-Oxley Act, Enron/WorldCom have again taken center stage in the corporate governance movement.

The proposed Enron/WorldCom settlements (they are both still subject to court approval), together with the recent Disney/Ovitz litigation, are sending one message – directors must not only take steps to assure that sound corporate governance practices and procedures are in place, they must be committed to the ongoing process of making sure that these practices and procedures are effective. In today's world, token adherence to corporate formalities and reforms is a recipe for trouble.

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Electronic Billing: Glum Times for e-Invoices?

David Whelan

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Four years into the century, and verbs beginning with e- remain hot. Electronic billing, or e-billing, has been a commonplace among businesses outside the legal profession for some years. It remains, however, a much more complex concept than the shortcut name might imply.

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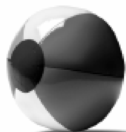

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The Proposed Enron/WorldCom Settlements

The corporate legal and business community once regarded securities class action suits as "strike suits" by plaintiffs' lawyers, representing nominal plaintiffs with no real interest in the outcome of the litigation other than a quick settlement, with substantial professional fees. With the passage of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") that all changed. The PSLRA has "lead plaintiff" provisions, which effectively provide that the plaintiff that should be in control of a securities class action suit is the plaintiff that "has the largest financial interest in the relief sought by the class." This has resulted in institutional investors increasingly taking charge of securities class action suits. One recent study indicates that institutional investors were the lead plaintiffs in approximately 50% of the securities class action suits filed in 2002 and 2003 compared with only about 15% in the pre-PSLRA era.

The New York State Common Retirement Fund (the "NYSCRF") is the lead plaintiff in the WorldCom lawsuit and the University of California ("UC") is the lead plaintiff in the Enron lawsuit. On January 7, 2005, each of them issued separate press releases announcing their respective proposed settlements with former directors. In the NYSCRF release, Alan Hevesi, New York's Comptroller, commented that the proposed WorldCom settlement "sends a strong message to directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent." James Hoist, UC's general counsel, noted in UC's press release that "it is especially significant that outside directors" were made to pay.

The proposed settlements are striking examples of how securities class action lawsuits have changed. Rather than questioning the value and validity of securities class action lawsuits, institutional investors have embraced them as vehicles for reform. Institutional investors, with significant dollars at risk and whose lifeblood is dependent on fair and honest securities markets, are learning first hand the extent of the malfeasance at the heart of these actions. As a result, they are pressuring their lawyers to use the settlement process to achieve results that implement significant corporate governance reforms and highlight the importance of what can happen in a corporate culture in which directors are not informed and committed and do not effectively discharge their fiduciary duties to shareholders.

Proposed WorldCom Settlement

Ten former outside directors of WorldCom have agreed to pay 20% of their cumulative net worth, excluding the value of their primary residences and retirement accounts, or a total of $18 million, to settle claims against them in the lawsuit. Insurers who provided director/officer coverage will contribute another $36 million for a total settlement of $54 million relating to the ten outside directors' settlement. In the course of the proceeding, the settling directors were required to submit sworn net worth statements that were subject to review. The directors were under extraordinary pressure to settle since they faced a jury trial beginning February 28, 2005. The settling directors have agreed to cooperate with plaintiffs in the litigation that continues against 17 investment banks, Enron's former auditor, and the remaining directors.

Proposed Enron Settlement

Eighteen former directors of Enron are contributing $13 million in personal funds, with director and officer insurers contributing an additional $155 million towards the $168 million being paid to settle certain claims against these particular directors. The directors' portion reflects ten percent of the profits they made from Enron stock transactions. The agreement represents the fourth settlement reached by UC on behalf of the plaintiffs in this lawsuit. UC reached a $222.5 million settlement with Lehman Brothers in October 2004, a $69 million settlement with Bank of America in July 2004, and a $40 million settlement in July 2002 that dismissed non-U.S. member firms of Arthur Anderson from the lawsuit. The lawsuit continues against a number of investment and commercial banks, former executives of Enron,

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the remaining directors, and two law firms. UC anticipates substantial additional recoveries as the lawsuit progresses.

While many of the settling directors in both Enron and WorldCom may honestly claim that they never knew the books were being "cooked," they were faulted in internal investigations for a reluctance to challenge top executives and failing to inquire closely into the details of major transactions. Given the outrageous facts in Enron and WorldCom, and the potential size of any recovery, the willingness of the directors to pay in the proposed settlements is understandable.

The Disney/Ovitz Litigation Saga

The Disney litigation involves an interesting corporate governance question – why, or better yet, how could the Board of Directors of Disney, a public company, allow shareholder money to be used to pay Michael Ovitz $140 million in cash and stock to go away quietly after barely a year of service as President (and not very good service at that, according to the testimony of those involved). As one corporate executive commented, "We give our good people a gold watch after 30 years of service, and the laggards walk away with a pot of gold." While the Disney/Ovitz litigation is an embarrassing drama for the Hollywood moguls, high profile directors, and lawyers involved and makes for good entertainment, the fact that the lawsuit has gone to trial tells quite a bit about how far the latest phase of the corporate governance movement has progressed.

In 2003, the Delaware Chancery Court refused to grant the directors' motion to dismiss the lawsuit and instead let the lawsuit proceed to the trial that has generated so much recent press. The defendants had moved to dismiss the lawsuit on the basis that the complaint in the lawsuit alleged at most a breach of a director's duty of care and, in that event, a provision in Disney's certificate of incorporation, based on Section 102(b)(7) of the Delaware General Corporation Law, served to protect individual directors from personal liability for money damages. (Such a provision generally bars any claim for monetary damages against a director based solely on the director's breach of his duty of care). A Section 102(b)(7) provision does not, however, among other things, "eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; [or] (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law."

The Court held that the facts in Disney, if assumed to be true, painted a picture where the directors may not only have breached their duty of due care, but engaged in a course of conduct in which the directors failed to exercise any care, even if it was defective. On that basis, the Court was able to conclude that the complaint identified a course of conduct that may have involved "bad faith" and raised the question of "whether the directors honestly and in good faith believed that the

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action was in the best interests of the corporation." In the words of the Delaware Chancellor:

"It is of course true that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions.... But our corporation law's theoretical justification for disregarding honest errors simply does not apply to intentional misconduct or to egregious process failures that implicate the foundational directorial obligation to act honestly and in good faith to advance corporate interests. Because the facts alleged here, if true, portray directors consciously indifferent to a material issue facing the corporation, the law must be strong enough to intervene against abuse of trust." (emphasis added)

The decision of the Delaware court that the suit against the Disney directors could proceed to trial is an example of how courts will not, in the post-Enron/WorldCom era, allow exculpatory charter provisions to protect directors from "egregious process failures" that lead to an "abuse of trust."

The SEC Weighs In

The Securities and Exchange Commission has a long standing policy of challenging indemnification provisions that purport to indemnify directors against personal loss when violations of the Federal securities laws are involved. More recently, the SEC has put teeth into its policy by requiring directors that are settling SEC enforcement proceedings to represent in writing that they will not be indemnified for any SEC fines that they have agreed to pay in connection with the settlement.

Conclusion

Corporate reforms brought about because of the outrageous failings of our corporate processes and systems continue to take hold, placing greater expectations on directors. Institutional shareholders, the courts and the SEC are finding ways, despite exculpatory charter provisions, director and officer liability insurance, and indemnification agreements, to make directors pay for failing to be diligent and independent in fulfilling their fiduciary obligations to shareholders.

Directors of corporations, whether public or private, for profit or not-for-profit, are rightfully concerned about the rising expectations they face and their enhanced exposure to criticism or liability. While apprehension is understandable, and precautions are appropriate, we believe that informed and committed directors, following sound advice with reasonable procedures and exercising consciously independent judgment, can fulfill their responsibilities with adequate assurance that their performance will not subject them to personal loss. Directors who are not informed and committed to the effective execution of sound corporate governance procedures and practices face perils like those discussed above.

For More Information

Please contact any member of our Corporate Transactions & Securities practice group.

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CaseMaker Training at NKU

The Chase Law Library will offer CaseMaker training on 4/14/05 from 5:15 to 6:15pm. An OSBA representative will review the cost effective benefits of using CaseMaker. The program title is **CaseMaker: The Online Tool for Kentucky and Ohio Lawyers**. The KY Bar Association is planning to offer the CaseMaker service to members this year. Pizza and soft drinks are provided. An RSVP is recommended to ensure that there will be enough food and enough seating. Please RSVP to Carol Furnish at 859-572-5396 or furnish@nku.edu by 4/12/05. Paralegals and librarians are invited.

E-Billing, cont'd from page 1

The LawNet 2004 E-billing Survey has just been released, and the latest version outlines the obstacles faced by law firms using e-billing and the not inconsequential costs associated with it. LawNet Inc. is an independent network of legal technology professionals. It offers regional and national conferences, as well as numerous white papers and surveys that are published and offered on its website, http://www.peertopeer.org.

Its latest e-billing survey discusses issues that will arise after the selection and implementation of an e-billing product, and the results were not necessarily happy. It should not scare firms from moving towards e-billing, but there appear to be greater benefits for the firm's clients and fewer savings for the law firm than might be anticipated.

What is E-Billing?

First, let's clarify what e-billing is. It is not a business-to-consumer relationship, but rather involves two businesses sharing information, with the law firm transmitting, in an electronic format, data used to generate a paper bill.

Sixty-seven of the 68 firms in the LawNet study use e-billing; about half have more than 150 timekeepers.

This is surprisingly high, when compared with recent surveys. For example, a 2004 poll by LexisNexis Martindale-Hubbell and Corporate Legal Times found that 61.9 percent of law firm lawyers said their firms offered e-billing, while only 8.2 percent of the general counsels reported using e-billing.

A 2003 report by Altman Weil found that 7.7 percent of law departments are using e-billing and 2.8 percent are making plans to convert. This percentage is slightly higher than LawNet's similar 2002 survey, when 93 percent of respondents indicated they were doing some type of e-billing.

Not Simple

The new LawNet survey appears to debunk assumptions about the promise of e-billing.

First, the simplicity offered by using standardized billing formats is elusive. Ideally, when the e-billing systems talk to one another, they share a common language. Two file format standards — Uniform Task-Based Management System (UTBMS) and the Legal Electronic Data Exchange Standard (LEDES) — have been created specifically to simplify these transactions.

Yet only 36 percent of firms responding communicated with clients using only one format; 33 percent used two formats; and the remainder used three formats or more (the highest being 10). Many firms reported that they were asked to customize the base format to accommodate a client's system, which not only defeats the purpose of the standard but makes supporting the new version difficult for technology staff.

These tweaks for each client put a spotlight on the administration and customization of the system. E-billing systems use templates to identify which data is to be transmitted. A new client may be able to use an existing template, which is simple to accommodate. But when a new template was involved, respondents indicated that an average of 127 hours and $1,485 was required to set up a new e-billing client. These are typically one-time costs, although 12 percent of firms had received as many as 10 change requests in the previous 12 months from a client, and 2 percent had received as many as 20 change requests.

Timing

Respondents noted the lag time between a firm's e-billing system being available to a client, and that client's termination of acceptance of paper invoices, during which the client would not pay. Only 18 percent of the firms reported that they could get through the setup process with a client, including having the client's e-billing systems work, in less than 30 days; 35 percent reported that it would take more than 50 days. This potential income flux, which could be substantial if e-billing is being done at the request of a large client, will need adequate anticipation and is a process that the law firm should spend additional resources on to keep as brief as possible.

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Offsets

E-billing is touted for its efficiencies in eliminating data entry errors and providing additional, detailed information. But these efficiencies are offset by an almost manual process to ensure the data going to the client is correct. The process enables a transmission of data to the client, whose system then typically validates task codes and billing rates. If the transmission fails the check, it is rejected and the law firm must fix the errors.

On average, only 19 percent of invoices had to be resubmitted. In this number lie a few significant issues for the law firm, where respondents noted that:

- 91 percent clean up the invoice data before creating the electronic invoice file.
- 90 percent manually modify the invoice file.
- 81 percent spend time checking it for compliance prior to submitting it to the client.

Law firms that commit to multiple formats and customizations place themselves in a position where the staff time saved in their finance departments may be eaten up by increased time used by technology staff — or may be a wash in finance, because the person involved with paper bills is now cleansing electronic data.

Balancing Act

The most beneficial result of this survey is that it highlights the balance a law firm needs to engage in when considering e-billing.

While clients seem to be the impetus behind law firms, big and small, moving to e-billing, they are not picking up the costs.

Firms responding to this survey appear to be paying $68 per invoice in order to do e-billing. This includes the soft costs of time spent by staff to process the data.

It also includes the vendor fees, which range from $0 for 10 percent of respondents, to as much as $30,000 a year for 24 percent of respondents.

It is worth noting that 75 percent of respondents' clients were using an external vendor, to whom the law firm transmits its data. That vendor, through an annual fee or through a percentage of the invoice amounts processed of as much as 3 percent per invoice, is an ongoing cost for e-billing services. The total cost of e-billing over the past 12 months for respondents ranged from less than $10,000 for 12 percent, to over $200,000 for 14 percent. This might make sense if the law firm were to move entirely to e-billing. But articles on the topic in the past 18 months typically note firms billing only as much as 10 percent electronically. The average firm in the LawNet survey sent about 5 percent of its invoices electronically.

Electronic billing offers your clients a powerful tool to measure your firm's work and it can help you stand out positively among your competitors at a time when general counsel have the reduction of costs as the number one concern.

The costs of getting into e-billing must be balanced against the business generated by the client demanding it and the additional soft and hard costs the firm will incur to maintain the system.

The future of e-billing may be bright, but it will require your firm to apply a lot of polish and elbow grease to keep it that way.

Library Adds Digital Copiers

Ever had to wait 4 minutes for one of the Library's copiers to come to life? No longer. We have replaced the Library's 10 year-old copiers with a pair of digital Xerox copiers. These copiers are quiet, quick to turn on, and easy to use. They both provide high-quality photocopies and provide features we have not had in the past, like automatic document feeders for large documents.

Look for additional functions in the near future! One of the copiers is a "multi-function" printer, and is a photocopier, a scanner, and a network printer all in one. We will be connecting it up to the Library's network, to enable members to scan in documents directly to our PCs or to print off research and documents directly to the copier.

E-Discovery CLE at the Law Library

The Cincinnati Law Library will offer a one-hour CLE led by **Thomas Y. Allman**, Sr. VP and General Counsel of BASF Corporation, at the Cincinnati Law Library Association, called **Are National Standards Needed? Proposed E-Discovery Amendments to the Federal Rules**. This course has been approved by the Ohio Supreme Court Commission on Continuing Legal Education for 1 CLE credit hour (1 hour of general credit).

Join us at the Law Library on Thursday, April 14, 2005, from 11am-12pm. Library Association **members: $10**; Non-members: $25. Please call Madonna Stoneking at (513) 946-5300 to reserve a place or register online at:
http://www.hamilton-co.org/cinlawlib/cle/signup.html.

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