

What's \$13 Million Among Friends?

By LUCIAN BEBCHUK

Cambridge, Mass. — TEN former directors of Enron have agreed to pay \$13 million from their own pockets to settle a class action suit stemming from Enron's collapse in 2001, which wiped out some \$60 billion in shareholder value. Because directors almost never have to pay even a penny in such suits, the Enron settlement - announced just days after several former WorldCom directors agreed to a similar deal - was widely viewed as a significant development that could discourage potential directors from serving on corporate boards.

This view is mistaken. A close look at the settlement shows that Enron's directors have still not been held accountable in any meaningful way.

Of the 18 former directors who were defendants in the Enron case, only 10 have to pay under the settlement. More important, according to the complaint against them, these 10 sold Enron shares worth more than \$250 million during the period in which Enron was misreporting its financial affairs. According to the lawyer for the lead plaintiffs, the settlement requires each of these 10 to pay an amount equal to 10 percent of his or her pretax profits. They will be able to keep the other 90 percent - which amounts to \$117 million - while investors who held their Enron stock lost their shirts.

The other eight Enron directors will not pay a penny but nonetheless have all claims against them settled. These directors did not sell shares before their value evaporated, which is presumably why they are not contributing. But they played important roles in the board's oversight failure. They include three of the six members of Enron's audit committee as well as six of the eight members of the finance committee, which reviewed many transactions that Enron used to deceive investors. Despite their role in the oversight failure, these eight directors emerge from Enron's ruins without having to pay a cent.

In a 2002 report, a Senate subcommittee concluded that by failing to protect shareholders' interests and ignoring questionable business practices, the Enron board "contributed to the company's collapse and bears a share of the responsibility for it." With the cases against them settled without any admission of wrongdoing, determining the directors' precise share of responsibility will be left to the judgment of history. But one thing will

be clear: their share of the cost will be trivial.

One reason for the directors' ability to walk away relatively scot-free lies in the incentives for the other parties in the litigation. Plaintiffs' lawyers naturally focus on maximizing the total recovery to the class - and therefore on the defendants with the deepest pockets - and not on what portion will be paid by individual directors. Insurance companies are in the business of providing broad protection to directors, who pay for it in advance with shareholders' money.

For these reasons, as well as for various legal rules and charter provisions that protect directors from liability, failing directors practically never have to pay personally for violations of their fiduciary duties. Although these duties are in theory a foundation of the corporate system, their practical significance is far more limited than most investors appreciate.

With Enron, the failure of the board had disastrous consequences, leading to the second largest bankruptcy in American history and shaking investor confidence. It is difficult to envision a stronger case for imposing a meaningful financial penalty on directors. Yet the settlement fails to do so.

The settlement hardly heralds a new era in which directors who fail to act in shareholders' interests pay the price. If even Enron's board members are treated this gently, then other corporate directors can rest easy.

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