



THE DELVES GROUP

*Director Liability for Executive Pay*

January 25, 2005

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## *Legal Requirements for Corporations*

Prior to the WorldCom case, most directors assumed that so long as their “actions were executed in good faith,” the ‘business judgment rule’ could shield them from any personal liability. Although the rule is still pertinent to determining directors’ liability, it is important to understand the legislative requirements regarding executive compensation, as well. Corporate legislation is divided between federal and state provisions, as follows:

- Federal Requirements under the Sarbanes and Oxley Act 2002
  - Proper disclosure of Executive Compensation in proxy statements filed to SEC
  - Executive Compensation Regulations
    - Public companies are prohibited from extending personal loans to directors or executives.
    - Insiders cannot trade company stock during blackout periods
- State Corporation Requirements
  - For-Profit Corporations
    - For-profit corporations do not have any provisions regarding the magnitude or nature of executive compensation.
    - However, these corporations must disclose details regarding executive compensation under federal filing requirements
  - Not-for-profit Corporations
    - Non-profit organizations that receive tax exemptions have direct regulations regarding executive compensation.
      - Compensation must be in line with responsibilities of executives
      - Compensation must be “reasonable” relative to peers (other non-profit organizations).

## *Case Study Overviews*

*The following section presents brief overviews of five of the more recent cases involving director liability. Each of these cases is discussed in greater detail in the next section of this primer.*

### **World Com: Accounting Scandal and Founder's Compensation (New York Case)**

- WorldCom was charged with overstating cash flow by reporting \$3.8 billion in operating expenses as a capital expense and giving founder Bernard Ebbers \$400 million in off-the-books loans.<sup>1</sup>
- Under a proposed settlement, 10 former independent directors have agreed to pay \$54 million (\$18 million out of pocket) to settle a class-action suit relating to the WorldCom accounting scandal<sup>2</sup>
- This case signifies the first time directors themselves paid for a settlement. (Directors usually are covered under executive and director liability insurance taken out by company.)

### **Tyco: Kozlowski's Compensation: SEC vs. Tyco Executives**

- The Tyco controversy surrounded SEC filings on executive compensation for the CEO, CFO, and General Counsel.
- The named executives received unauthorized compensation worth several hundred million dollars in the form of loans that were not disclosed to the Board, shareholders, or the SEC.<sup>3</sup>
- Neither the distribution nor the repayment of the loans themselves was illegal, since the Company allowed for these loans if approved by the Board. The violation occurred because the named executives did not disclose said loans for Board approval.<sup>4</sup>
- This case did not deal directly with board liability since the executives were at fault for misrepresentations; however, SEC filings on executive compensation fall under the purview of the Board of Directors.

### **NYSE: Dick Grasso Compensation and Severance Package (New York Case)**

- SEC scrutinized the NYSE head's compensation and severance package following his termination.
- The initial ruling left the case under the state's jurisdiction. Grasso's compensation was in violation of New York State Not-For-Profit Compensation Law (NPCL) which states that non-profit executive compensation must be commensurate with services rendered and should be on par with peers (other non-profits).<sup>5</sup>
- Board liability is introduced since Grasso's compensation was under the Compensation Committee's discretion. After the initial investigation, Board members adjusted Grasso's severance package.<sup>6</sup>

### **Disney: Investor's vs. Disney (Michael Ovitz) (Delaware Case)**

- Disney hired Michael Ovitz.
- CEO Michael Eisner requested the termination of Ovitz's employment.
- Subsequently a \$140 million severance package was paid out to Ovitz after only a few months of service.<sup>7</sup>
- Evidence suggests that the Board of Directors did not play a role in the severance decision (leaving the decision to management, while the matter was partially under their jurisdiction).
- The trial signified the first case in which directors' liability for an executive compensation decision has come under scrutiny by a state court.

### **Fannie Mae: CEO Raines's Severance Package**

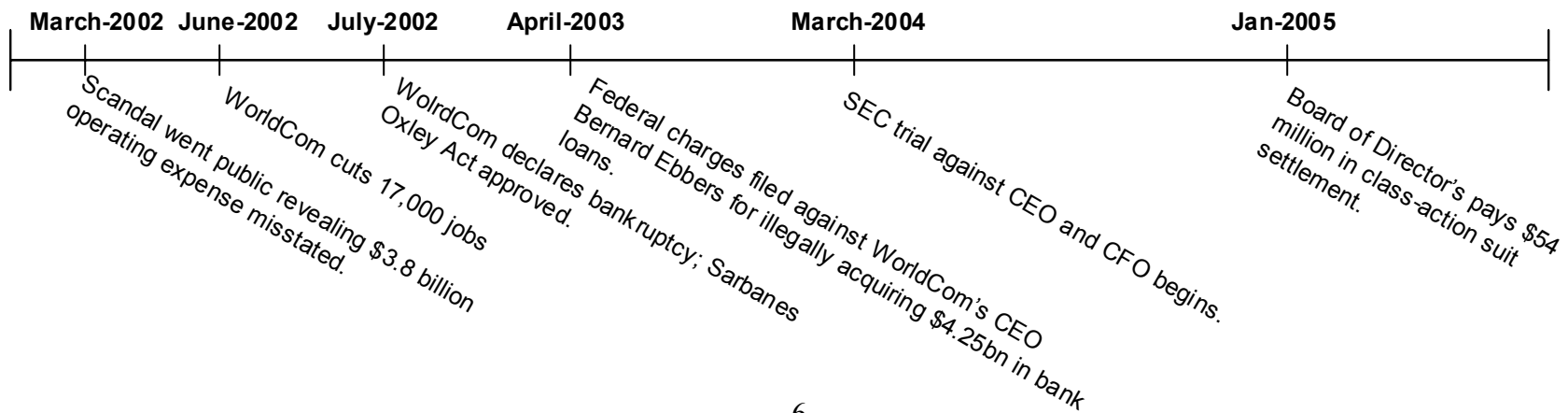
- SEC found Fannie Mae accountable for misstating \$9 billion in profits.<sup>8</sup>
- Upon the finding, Fannie Mae's Board made adjustments to Raines's retirement agreement by both increasing the pension to include a \$1.4 million payout for life, and altering the "termination for cause" definition to ensure Raines's received an early retirement package upon leaving the company.<sup>9</sup>
- Severance package for Fannie Mae executives are especially controversial because the Company is a quasi-public institution that receives a federal government guarantee on its debts to better service the home mortgage market.
- As a result of escalating pressure from the regulators, Fannie Mae's Board called for the resignation of Raines and his CFO, Timothy Howard in December 2004.<sup>10</sup>

## Case Study Details

### WorldCom

**Summary of Events:** Following the onset of the Enron accounting scandal the previous year, reports surfaced in early 2002 that WorldCom (the US's second largest telecom) had misstated a \$3.8 billion operating expense as a capital expense in its financial statements for FY 2001. This enabled the Company to treat the ordinary expense as an investment and amortize the amount over a number of years (thereby claiming a \$1.3 billion profit in 2001 instead of a loss.)<sup>11</sup> During the course of 2002, accounting fraud charges continued to emerge bringing the misstatement total to \$11 billion.<sup>12</sup> Additionally, WorldCom's founder and CEO was accused of personally spending over \$400 million in off-the-books loans (paid out to supposedly service payments on WorldCom shares purchased to fulfill stock ownership requirements).<sup>13</sup> In this particular case, charges against the Board of Directors was two-prong: first and foremost the Compensation Committee was held responsible for CEO loans, and the Accounting Committee was held liable for the charges of accounting fraud.

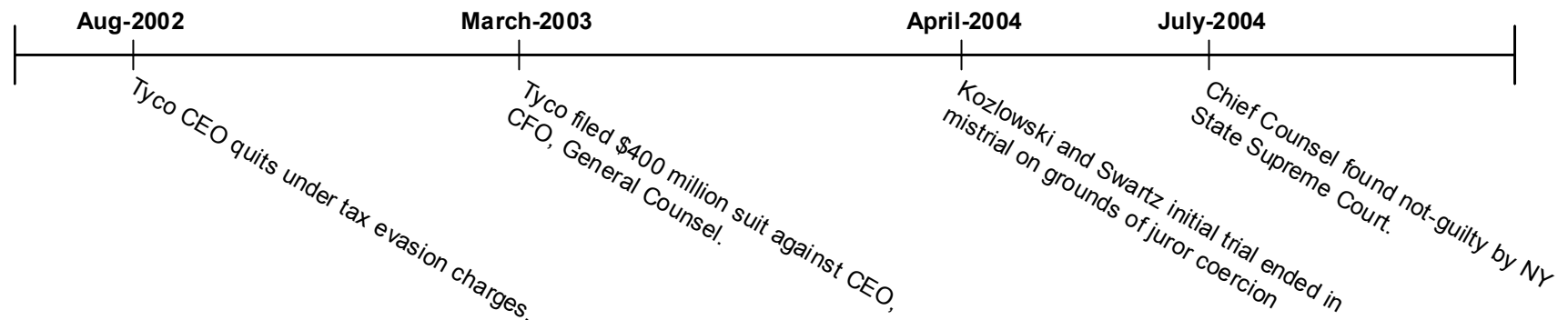
**Director's Liability Issues:** Just recently on 7 January 2004, WorldCom's Board of Directors agreed to pay \$54 million (\$18 million out-of-pocket) to settle a class-action suit.<sup>14</sup> Normally the executive and director liability insurance taken out by a corporation covers the full amount of any fines against directors. However, the settlement marks the first time directors have been forced to personally pay for charges against them. The directors' settlement marks a new chapter in director liability for negligence concerning accounting matters. The WorldCom case has pertinent implications for the more recent Chicago Sun-Times case (Hollinger International) in which executives including the CEO Conrad Black are being investigated for improperly embezzling millions in company funds. Since directors at Hollinger did not regularly attend board meetings or thoroughly scrutinize accounting statements, sheer negligence could lead to charges filed against them.<sup>15</sup>



## Tyco

**Summary of Events:** In September of 2002, the SEC filed criminal and civil fraud charges against three top Tyco executives: the CEO (Dennis Kozlowski), CFO (Mark Swartz), and General Counsel (Mark Belnick). The named executives received unauthorized compensation worth several hundred million dollars in the form of loans that were not disclosed to the Board, shareholders, or the SEC. Allegedly Kozlowski and Swartz used \$322 million in Company loans to fund personal expenses and then illegally granted themselves loan forgiveness.<sup>16</sup> Under Tyco's Key Employee Corporate Loan Program (established in 1983), executives could take out corporate loans to pay taxes incurred when restricted shares in the Company vest.<sup>17</sup> If approved by the Board of Directors, neither the distribution nor the repayment requirements of the loans in and of themselves would have been illegal. However, each executive's failure to disclose the loans for Board approval violated the loan provisions. In addition, the CEO was accused of tax evasion regarding the personal purchase of rare painting from art galleries in New York and London by documenting each purchase as a corporate expense.<sup>18</sup> In the Chief Counsel's case, Belnick was accused of illegally obtaining \$14 million in loan money for relocation from New Hampshire to New York when joining the firm in 1998.<sup>19</sup>

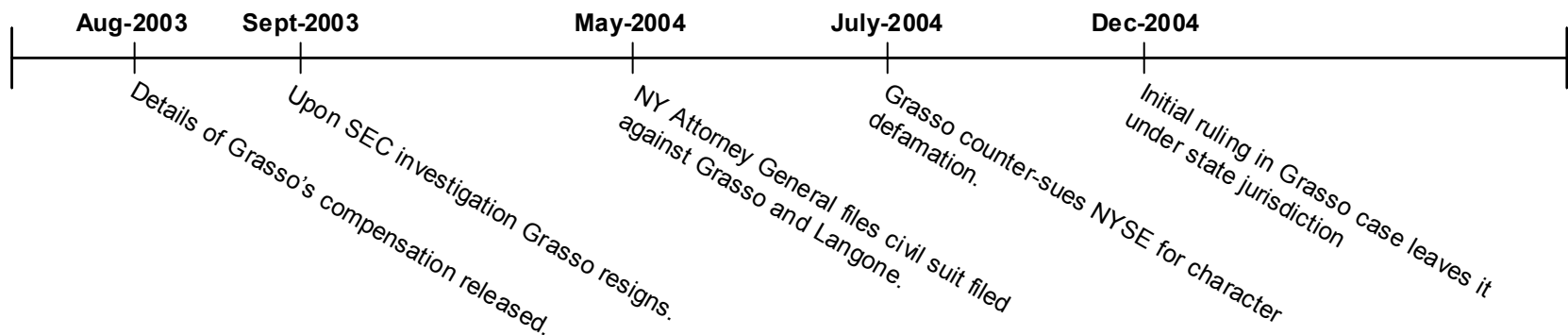
**Director's Liability Issues:** Despite all of Tyco's wrongdoings, the magnitude of Company loans themselves did not constitute a violation of either federal or state regulations (as indicated by the General Counsel's acquittal on fraud charges in July of 2004). Unlike non-profits, there are no direct federal or state checks on the size of executive compensation packages at private companies. However, private companies must abide by the SEC disclosure rules on executive compensation – rules established both prior to and under the Sarbanes-Oxley Act. Although disclosure responsibility lies under the jurisdiction of the Board of Directors, since the executive officers did not receive Board authorization for the provisions of the loans in question, the directors cannot be held liable for executive violations.



## NYSE

**Summary of Events:** In August of 2003, details of NYSE head, Richard Grasso’s \$187 million pay package were released.<sup>20</sup> Following intense scrutiny by the SEC, Grasso resigned from the NYSE citing his decision as a termination by the exchange. Grasso’s excessive compensation package raised eyebrows since it was in violation of New York State Not-For-Profit Compensation Law (NPCL).<sup>21</sup> This law states that non-profit executive compensation must be “reasonable”, commensurate with services rendered, and aligned with peers (other non-profits). Grasso stood behind his compensation claiming that it was rightfully earned after 65 years of loyal service to the exchange. However additional allegations arose that Kenneth Langone (Chairman of the Compensation Committee, and close personal friend of Grasso’s) bullied other directors into accepting Grasso’s pay package.<sup>22</sup> In May of 2004, the New York Attorney General, Elliot Spitzer filed a civil suit against both Grasso and Langone demanding Grasso pay back \$100 million, and Langone pay back \$18 million.<sup>23</sup> The main controversy arising in the lawsuit related to whether Grasso’s compensation fell under the jurisdiction of the state court (and its not-for-profit compensation laws), or of the federal court (in which NPCL violations could not be cited). In early December, an initial ruling by U.S. District Court Judge, Gerard Lynch, declared that the case was a state matter allowing the trial to continue. This case is still pending.

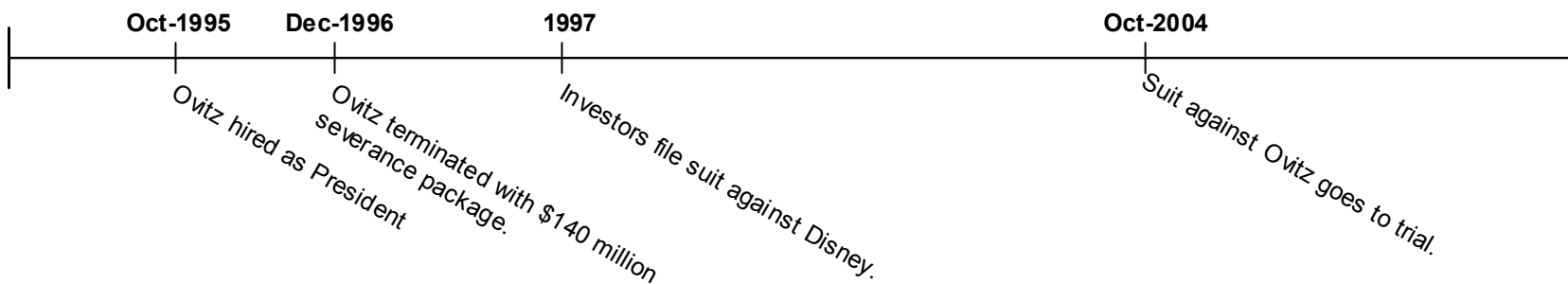
**Director’s Liability Issues:** Board liability in this matter is introduced because Grasso’s compensation was under the Compensation Committee’s discretion. Due to his close personal ties to Grasso, the fact that Langone served as the Chairman of the Compensation Committee could be construed as a conflict of interest. In the Grasso case, additional settlements have already been reached for the wrongdoing of the head of Human Resources at the NYSE, and Mercer Human Resource Consulting (which provided consulting services for the SEC regarding NYSE pay) concerning these matters. An important nuance of this case is the non-profit status of the NYSE. While it is a non-for-profit exchange and has certain regulatory provisions under the federal government’s jurisdiction, it does not enjoy the same tax-exemptions as other non-for-profits making the requirements of the New York NPCL more difficult to justify.



## Disney

**Summary:** In October of 1995, Disney CEO, Michael Eisner hired close personal friend, Michael Ovitz to serve as President of the corporation. After 15 months of service, Disney terminated Ovitz's employment allowing him to leave the Company with a severance package of \$140 million.<sup>24</sup> Due to the exorbitant nature of the severance amount after only a few months worth of service, Disney's investors filed a civil suit against the Company in 1997.<sup>25</sup> Through this suit (currently underway in a Delaware court), Disney investors have demanded that Ovitz, Eisner and other Disney directors, including actor Sidney Poitier, pay back the company treasury for the severance package with \$60 million in additional interest.<sup>26</sup>

**Director's Liability Issues:** Evidence suggests that the Board of Directors did not play a role in the severance decision (leaving the decision to management, even though the matter was partially under their jurisdiction). This trial signified the first case in which directors' liability for an executive compensation decision has come under scrutiny by a state court.





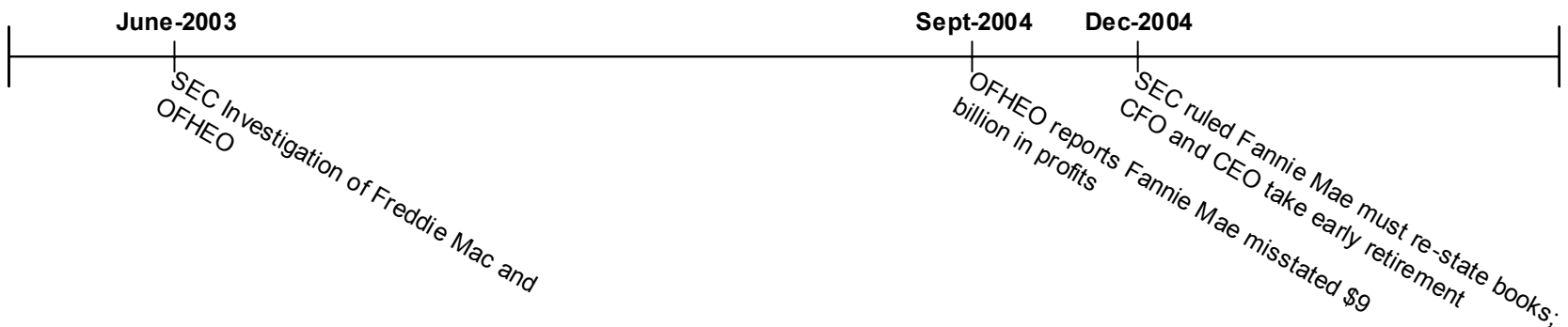
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**Fannie Mae**

**Summary:** Spurred by a SEC investigation in June of 2003 of Fannie Mae’s regulatory role in the mortgage market and its dealings with Freddie Mac, the Office of Federal Housing Enterprise Oversight (OFHEO) began to scrutinize the practices of Fannie Mae.<sup>27</sup> The OFHEO is the government regulatory agency responsible for overseeing the activities of organizations in the mortgage market which receive government guarantees on debt (e.g., Fannie Mae and Freddie Mac). In September of 2004, the OFHEO found that Fannie Mae had misstated \$9 billion in profits by using non-GAAP methods to spread its earnings more smoothly over consecutive quarters.<sup>28</sup>

This past December, the SEC found Fannie Mae accountable for its misstatements. Subsequently Fannie Mae’s Board got rid of both its CEO, Franklin D. Raines, and its CFO J. Timothy Howard, by allowing each to take an early retirement.<sup>29</sup> Under early retirement, Raines’ pension was adjusted to include a \$1.4 million payout for life, as well as an option grant valued at \$11.8 million that was fully vested and exercisable.<sup>30</sup> Recent reports have emerged alleging that 5 days before the OFHEO announced its investigation of Fannie Mae, the Chairman of the Compensation Committee, Anne Mulcahy, amended Raines’s employment agreement and adjusted the “termination for cause” definition in such a way that Raines’s would be more likely to remain eligible for his early retirement package pending the outcome of the investigation.<sup>31</sup>

**Director’s Liability Issues:** The severance packages for Fannie Mae’s executives are especially controversial because of the Company’s standing as a quasi-public institution. Although it is **not** a non-profit, many feel that the Company’s status as a quasi-public institution should result in more stringent regulation of executive pay by regulators. In addition, the nature of the amended employment agreements raises concerns regarding whether Fannie Mae’s Board of Directors acted in the best interests of its investors by changing retirement provisions.



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