SECURITIES LAW360

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First In Time, First In Right

Wednesday, August 30, 2006 --- Andrew Fastow pled guilty. Kenneth Lay and Jeffrey Skilling were convicted. Scores of other directors and officers who gathered around U.S. corporate conference tables in recent years have since become the subject of civil lawsuits or criminal indictments or both. The recent guilty verdict against Enron's top two executives is but one more domino to fall in a series of corporate scandals that have ricocheted through America's boardrooms and courtrooms during the past decade.

The same scandals were the catalyst behind the passage of The Public Company Accounting Reform And Investor Protection Act of 2002—better known as Sarbanes-Oxley—Congress' rapid response to what it perceived as an epidemic of corporate malfeasance, which has certainly added to boardroom pressures for corporations both large and small.

In the midst of this turmoil stands the D&O insurer, often the first line of defense for U.S. corporate directors and officers alleged to have engaged in wrongdoing. Undoubtedly, absent D&O insurance, American corporations would be hard-pressed to find experienced talent willing to sit on the boards of for-profit corporations, whether publicly or privately held.

As noted by the United States District Court for the Southern District of New York, "Unless directors can rely on the protections given D&O policies, good and competent men and women will be reluctant to serve on corporate boards." In Re Worldcom Securities Litigation, 354 F. Supp. 2d 455, 469 (S.D.N.Y. 2005).

In fact, even directors and officers of nonprofit corporations are beginning to recognize their personal risk in accepting board seats. A 2005 Tillinghast Survey reported that 30% of nonprofit participants—compared to 50% of for-profit participants—responded in the affirmative when asked if potential directors inquired about D&O insurance. See also Nonprofits Especially Need Protection Against D&O Liability Risks, Insurance Journal, Sept. 17, 2001 at http://www.insurancejournal.com.

This modern expansion of D&O insurance beyond high-priced corporate boardrooms shows just how deeply the idea of D&O protection has taken root in the collective American business psyche. While D&O insurance is intended to reimburse or advance a director or officer for costs incurred either in defending a civil suit or to indemnify them for any unfavorable judgment or settlement, the risk is that many of the director and officer beneficiaries of corporate D&O policies do not realize that their D&O safety nets are sometimes stretched too thin.

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One significant risk an insured director often does not appreciate is that his or her D&O coverage might be exhausted when another director or officer or even the corporation reaches the policy limits first.

Considering the reliance U.S. industry has placed on D&O insurance, it is a surprisingly young insurance product. It originated during another turbulent era in the financial markets. First introduced to the American market by Lloyd's during the Great Depression in the 1930s, D&O insurance did not take hold in America until more than 30 years later.
Then, spurred on by a spate of savings and loan scandals in the 1980s, it rapidly became a must-have in corporate director compensation packages.

More than 90% of Fortune 500 companies now carry D&O protection, with increasing numbers of small and midsized companies and nonprofit corporations adding it to their insurance portfolios. See Roberta Romano, WhatWentWrong with Directors' and Officers' Liability Insurance?, Delaware Journal of Corporate Law, 14 Del. J. Corp. L. (Winter 1989); Ira M. Millstein, Directors' Institute on Corporate Governance: What Board Members Need to Know to Be Effective Today & Tomorrow (Practicing Law Institute 2004); Carl H. Loewenson, Jr.& Randy Paar, D&O Liability & Insurance 2004—Directors & Officers Under Fire (Practicing Law Institute 2004).

Three types of D&O insurance are commonly available in the United States. For descriptions of the types of D&O insurance that are available see Professional Liability Insurance Vol. 1, International Risk Management Institute, Inc. (2005).

Side A coverage protects directors and officers against claims for which the corporate entity is either prohibited from indemnifying its directors and officers by virtue of state or federal laws or under the corporation's bylaws (such as for shareholder derivative suits) or in situations where the corporate entity is not able to pay (such as when it is in bankruptcy).

Side A coverage generally covers wrongful acts—even intentional wrongful acts—that occur in the performance of duties. Losses covered include judgments, settlements, and defense costs, but usually not disgorgement or punitive penalties, for which reimbursement is frowned upon as a matter of public policy. Side A coverage broadens the protection for directors and officers.

Corporations frequently purchase Side A coverage in combination with traditional Side B coverage. Side B coverage is intended to reimburse the corporation for those claims that federal and state law and the corporate bylaws allow the corporation to indemnify its directors and officers.

Courts have held that D&O policies are intended to "safeguard" the interests of directors and officers and not to act as "a vehicle for corporate protection," yet the issue of who owns the policy and, more importantly, who owns the policy proceeds, is the subject of frequent dispute when a corporation is in bankruptcy. In Re First Central Financial Corp., 238 B.R. 9, 16 (Bankr.

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E.D.N.Y. 1999).

The majority of courts hold that D&O policies belong to the corporation even in bankruptcy. There is, however, a split as to whether the proceeds of a D&O policy belong to a debtor corporation or to its directors and officers. In Re Cybermedia, Inc., 280 B.R. 12 (Bankr. D. Mass. 2002) (citing cases on both sides of the argument). / continued page 8.

Some bankruptcy courts have interpreted Side B coverage as inuring to the benefit of the corporation, and have thus made the entire proceeds of the policy part of the bankruptcy estate. The risk of the proceeds being directed other than to the benefit of the directors and officers, however, is most likely to arise with regard to the third type of D&O insurance that is commonly available—Side C coverage, better known as entity coverage.

Side C coverage is a latecomer to the D&O product universe. Historically, the only insurance benefit to the corporation from D&O insurance was for reimbursement of indemnified claims. Side C is a creation of the 1990s and was a direct result of the surge in securities action during that decade. Side C coverage protects the corporate entity in respect of a director or officer's act or failure to act.

While a policy containing Side A, Side B, and Side C coverage might appear to be very broad, the additional coverage for the corporation can come at the expense of the coverage for the officers and directors.

A policy that is subject to a single aggregate limit yet intended to protect the directors and officers and the corporation runs three risks. The first risk is that the policy limits will exhaust before an insured director or officer needs it. The other two risks involve the impact if the corporation files for bankruptcy.

The D&O policy could become subject to the automatic stay in bankruptcy, thus preventing a director or officer from accessing defense funds and/or the proceeds of the policy might be made a part of the bankruptcy estate. Any of these outcomes can have serious ramifications for a director or officer who discovers that little or no coverage remains or is accessible when it is needed to cover defense costs or judgment or settlement amounts.

Thus, when a corporate entity files for bankruptcy, the existence of Side C coverage could prevent any of the directors or officers from accessing the policy and, if the proceeds of the policy are made part of the bankruptcy estate, the claims in the bankruptcy proceeding could exhaust the limits. The question of ownership of the proceeds, therefore, is frequently litigated.

Of course, even if the policy proceeds are not made part of the bankruptcy estate, a director or officer is still not guaranteed that the proceeds will be available for his or her needs. In jurisdictions such as New York, that follow a "first in time, first in right" rule, the first settling defendant director or officer might take a substantial piece of the proceeds of the policy leaving little or nothing for the other directors and officers.

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Frequently, an insurer will seek a court's aid in deciding how limited proceeds should be divided among numerous directors and officers. That was the case in the Southern District of Texas last year when Enron's D&O insurers filed an interpleader action in an effort to have the court decide how to divide the policy proceeds.

Enron had purchased one primary insurance policy and ten layered excess liability policies, totaling $350 million in coverage. By the time the insurance companies filed their interpleader action, the primary policy plus the first three excess policies had exhausted. The issue before the court involved the numerous demands on the remaining $200 million. As the court described it:

In October 2004 three different settlement demands from different insureds were made upon the Excess Insurers for payment from these remaining proceeds. First, eighteen of Enron's former Outside Directors sent a letter dated October 12, 2004 informing the carriers that they had reached a settlement [in Action A], an agreement which would require payment of the entire $200 million [plus contributions from the insureds]. Another letter dated October 14, 2004 informed the Excess Insurers of a settlement in [Action B] between the Official Creditors Committee and [certain Outside Directors] for payment of 17.2% of the remaining insurance proceeds, which would reduce the amount to be paid [in Action A] . ... Finally, in a letter dated October 20, 2004, Kenneth Lay made a demand [for payment of] $10.25 million to settle claims against him in two Enronrelated suits. In Re Enron Corp. Securities, Derivative & ERISA Litigation, 391 F. Supp. 2d 541, 548 (S.D. Tex. Aug. 1, 2005).

Furthermore, Andrew Fastow sought to secure funds for his legal defense—even though he had pled guilty and the policy excluded coverage of criminal acts.

The nonsettling insureds argued that depleting the policies in favor of the settling defendants would violate New York law, which they claimed governed the policy. The court disagreed—both with the theory that New York law applied and with the non-settling insured's argument. Under New York law, the Texas court noted, "an insurer may settle with less than all of the claimants under a particular policy even if such settlement exhausts the policy proceeds. ... " Id. at 554.

Ultimately, the court, among other rulings, granted a motion to stay the proceedings with regard to the interpleader and the partial settlements, thereby avoiding the need to deplete the policy limits, but this moment in the Enron litigation represents a colorful example of how an unwary director or officer might be taken by surprise when seeking the benefit of a D&O policy.

The development of the D&O insurance market has mirrored our times from its introduction in the U.S. following the 1929 crash to its rapid expansion during the 1980s savings and loan crises to the creation of Side C coverage to protect corporate entities against securities claims in the 1990s. Directors

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and officers—at both for-profit corporations and nonprofit corporations—can help avoid the surprise of finding D&O coverage either unavailable or exhausted by becoming more knowledgeable consumers of D&O insurance.

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