K&LNG Alert

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Insurance Coverage

A Timely Lesson From The WorldCom And Enron Settlements: Make Sure Your D&O Program Is Adequate

Within the last few weeks, much has been written about the settlements of the claims brought by shareholders of WorldCom and Enron against the respective companies' former directors. In WorldCom, ten former outside directors agreed to contribute collectively $18 million, approximately 20% of their personal assets, exclusive of retirement and residential assets, toward a $54 million settlement. In Enron, a similarly-sized group of former outside directors agreed to contribute $13 million toward a $168 million settlement. The remainder of the settlements would be paid by directors and officers liability insurance. New York State Comptroller Alan G. Hevesi, the lead plaintiff in a civil suit against WorldCom's former outside directors, stated in a January 7, 2005 press release that the WorldCom settlement "sends a strong message to the directors of every publicly traded company" that plaintiffs "will hold [directors] personally liable if they allow management of the companies on whose boards they sit to commit fraud."

Prior to the Enron and WorldCom settlements, many had assumed that the personal assets of directors would virtually never be called upon to settle shareholder claims, at least where the Company purchased D&O insurance for the benefit of the directors. Now, however, it has been suggested that the personal assets of directors increasingly will be called upon to contribute toward settlement of shareholder claims.

At the outset, it must be noted that the Enron and WorldCom settlements, by any measure, arose out of extraordinary circumstances. It is far from clear that Enron and WorldCom, in fact, represent a trend requiring directors in less extraordinary circumstances to contribute to settlement of shareholder claims.

Nonetheless, the statements by Comptroller Hevesi and others understandably have raised serious concerns not only for outside directors but also for public companies seeking to recruit and retain highly qualified outside directors. Somewhat lost amid the publicity, however, is an important fact: the ability of the WorldCom and Enron directors to resist demands that they contribute their own assets towards settlement of the shareholder claims was significantly and, to some degree, negatively affected by the policy wording contained in, and/or limits of coverage provided by, the relevant D&O insurance contracts. In WorldCom, for example, nearly all of the D&O insurers asserted that, due to WorldCom's alleged misrepresentations to the insurers, the D&O policies were void **as to all of the directors**. Moreover, according to the insurers, the WorldCom D&O policies lacked a broad "severability" clause that would have protected the directors against rescission of their coverage due to alleged misrepresentations to the insurers. Had the directors of WorldCom been covered under broader policies (as discussed below), they may well have been better positioned to resist the demand of the shareholder plaintiffs that the directors contribute their personal funds. A critical lesson provided by the WorldCom and Enron settlements — for both outside directors and the companies on whose boards they sit — is that they need to ensure that the company's D&O program provides adequate protection for the directors. Below, we discuss several important considerations relating to so-called Side A-only and traditional D&O policies.

SIDE A-ONLY D&O COVERAGE

So-called Side A-only D&O policies provide insurance coverage for directors and officers against claims that are not indemnified by the company or, in some cases, that are not indemnifiable by the company. Most public companies do not purchase Side A-only policies, in large part because such policies can be extremely expensive and are not necessarily available to all companies. Nonetheless, a growing number of insurers offer such products, and companies increasingly are looking to purchase broad form Side A-only coverage. Some important aspects of Side A-only coverage are described below.

- **Misrepresentation/Rescission Issues**
  Many claims against directors are based on alleged errors in financial statements, public filings and press releases. Because companies often submitted the same documents to insurers to procure D&O insurance, insurers increasingly seek to use the underlying plaintiffs' allegations of errors in such documents as a basis to void D&O insurance policies. In certain situations, e.g., WorldCom, D&O insurers have contended that a false statement by a single officer can divest all directors and officers of coverage. This potential defense, if not properly addressed through appropriate policy wording, increases the pressure on directors to contribute their personal assets to settle shareholder claims.

  Most Side A-only policies contain favorable "severability" clauses, which, as noted, apparently were absent from the WorldCom program. This wording provides that coverage may be rescinded only as to the specific individual(s) that had actual knowledge of misstatements in the application. Indeed, some recently introduced Side A-only policies expressly state that the insurer will not seek to rescind coverage under any circumstances.

- **Bankruptcy**
  From the perspective of directors and officers, D&O insurance is perhaps most needed when a company or organization is in bankruptcy and is unable or unwilling to meet its obligation to advance defense costs and pay judgments or settlements. Yet, many traditional D&O policies contain potential impediments to accessing coverage in such circumstances. For example, because the corporate debtor is typically an insured under a traditional D&O policy (for, among other things, its own securities liability under so-called Side C coverage), bankruptcy trustees and creditors committees increasingly contend that the D&O policy is an asset of the estate and the proceeds thereof should be reserved for the debtor—not for the directors. A director seeking coverage under a Side A-only policy, however, should not be subject to this potential obstacle to coverage, because the Side A-only policies do not cover the company at all.

TRADITIONAL D&O COVERAGES

The traditional D&O insurance policy provides "Side A" coverage for non-indemnifiable loss, "Side B" coverage for the company's indemnity obligations to directors and officers, and "Side C" coverage for securities claims asserted directly against the company. Among the myriad of provisions that should be considered are the following:

- **"Priority Of Payments" Provisions**
  Traditional D&O policies may contain "priority of payments" provisions, which require that claims under the direct "Side A" coverage for directors and officers (*i.e.*, claims not indemnified by the corporation) are to be paid before claims under the "Side B" corporate reimbursement and "Side C" entity coverages. Where a policy contains this type of priority provision, courts likely will be less inclined to hold D&O policy proceeds to be an asset of the corporate debtor's estate and more inclined to allow the insured directors to obtain coverage thereunder.

- **Misrepresentation/Rescission Issues**
  As noted above, where a claim involves allegedly erroneous financial statements or public filings, a D&O insurer may attempt to rescind the D&O policy based upon alleged material misrepresentations, particularly if the insured submitted the same documents to the D&O insurers in applying for coverage. Also as noted above, D&O insurers increasingly have contended that a false statement by a single officer can divest **all** directors and officers of coverage under a D&O policy. A properly written "severability" clause can protect directors against this potential coverage defense by requiring that the insurer may invoke the defense as to a director **only** if the director was aware of the misrepresentation.

Given the recent settlements and predicted concomitant hardening of the insurance markets, companies and directors may find it prudent to take a close look at their existing D&O insurance programs so as to obtain a better understanding of what coverage is and is not provided, what can be done to enhance the protection provided, and what can be done to minimize efforts by the D&O insurers to reduce the coverage.

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