Executive Risks

Willis

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A Personal Matter

In January of 2005, corporate directors from two major entities agreed to settle Directors & Officers (D&O) litigation using personal assets. Since both companies had purchased D&O insurance coverage, these cases have given rise to much concern and speculation in both corporate boardrooms and at insurance carriers. Although the first of these two settlements was unable to garner the approval of the court and subsequently fell apart, the issues raised by both remain of real interest.

The proposed settlements announced by the independent or outside directors of WorldCom and Enron were surprising because these individuals seemed unlikely to have been personally involved in any of the alleged malfeasance at their companies. To date, where individuals have been held personally liable for D&O claims, they have been alleged direct participants in the fraud. In the past, absent a breach of the duty of care or a breach of loyalty, the business judgment rule has been sufficient to protect individual directors against liability from corporate transactions. Furthermore, the plaintiffs appear to be insisting that the individuals themselves, rather than insurance companies, pay a part of the settlement.

As we study these proposed settlements, important new trends in D&O litigation come into focus:

- The lead plaintiff, often an institutional investor, increasingly seeks payments from individual defendants
- Recoveries from corporate officers/directors are on the increase
- Outside directors are not immune

Under Sarbanes-Oxley (SOX), the Securities and Exchange Commission (SEC) was instructed to perform a study on amounts it had assessed and collected from individual defendants in securities enforcement actions. These amounts, few and far between, were not impressive; small amounts were often inconsistently assessed with an even poorer showing on collections. Perhaps in part as a result of this review, the SEC has reversed its decades-old strategy and is now pursuing recoveries from both companies and individuals in the form of fines and disgorgement. In fact, this is now an identified performance measurement of the SEC's overall effectiveness in enforcing the securities codes and deterring wrongdoing.

An examination of both recent settlements reveals the following identifying characteristics:

1. Institutional Investors as Lead Plaintiff

In 1995, the Private Securities Litigation Reform Act (SRA) mandated that the investor with the largest financial stake in any alleged malfeasance has the right to act as the lead plaintiff in securities litigation. This rule was established to prevent nuisance suits by individuals with little financial interest in the litigation. Mutual funds and pension funds tend to be the investors with the largest holdings in public companies. Since mutual funds, by and large, have demonstrated little interest in suing the companies that they invest in, pension funds (particularly large public pension funds) remain as the lead plaintiff in much of the new post-SRA securities litigation.

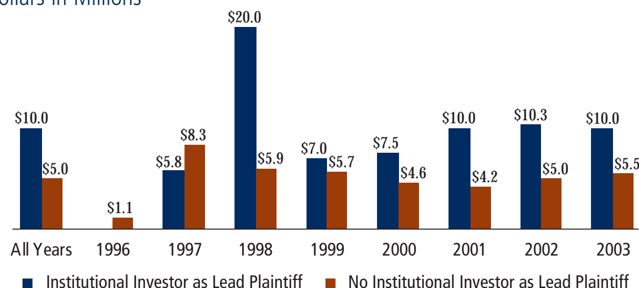
Not only are these groups bringing a greater percentage of the newer securities claims, but they also tend to concentrate on the suits with the largest losses and, therefore, ultimately achieve greater dollar settlements (even though

Due to the importance of the topic addressed in this issue – the personal liability of outside directors as seen in the proposed WorldCom and Enron D&O settlements – we are devoting the entire February newsletter to the exploration of this single topic and its potential impact on our clients' businesses. Expect to see further updates and analysis as events evolve.

such settlements may represent smaller overall percentages of total estimated damages). This is demonstrated in the chart below:

Median Settlement Amounts and Institutional Investors by Year

Dollars in Millions



With large losses often totaling in the tens of millions, if not hundreds of millions of dollars, institutional investors as a group are extremely motivated to pursue the individual defendants. So much so, that they have recently begun encouraging their counsel to go after the personal assets of the company directors and officers. At least one carrier involved in one of these settlements has labeled the almost religious fervor demonstrated by these plaintiffs a "crusade."

Some institutional investors, when acting as lead plaintiffs, are so determined to collect from the individual defendants that they have put "bounties" on recoveries, offering their legal teams 30-50 percent of what they recapture. While this phenomenon does not appear to be the case with WorldCom or Enron, it is expected to play a role in other ongoing and future securities litigation.

Without the other factors mentioned below, however, these same individual defendants may have been able to look to their companies as either co-defendants for contribution or for indemnity, and if the claims brought against them were not so significantly under-insured, they could have depended upon their insurance carriers to pay these claims on their behalf.

2. Limited Amounts of Coverage

As in all situations, both WorldCom and Enron had a limited amount of insurance available to fund their D&O claim settlements, and for both firms, the total insurance proceeds were dwarfed by the size of the claims made against the companies and their directors and officers. Clearly, WorldCom with $100 million in total limits had far less than Enron with its $300+ million in coverage, but when compared to the claims for tens of billions of dollars, both were significantly under-insured. In other words, the individuals, from the inception of their claims, faced potential individual liability far in excess of the insurance limits available.

In complex litigation, the costs associated with the investigation and defense of multiple, unconsolidated claims coming from multiple plaintiffs (federal regulators, bondholders, etc.) can be enormous, potentially amounting to millions of dollars per month in the most complicated situations. These costs erode and can exhaust available D&O coverage. Both WorldCom and Enron have or had substantial legal bills that are or were rapidly eroding their D&O limits.

3. Mega-Mega Claims

As mentioned above, in both instances, we are witnessing the financial meltdown or implosion of very large public companies. Given their gargantuan size, even if the entire market for D&O insurance limits had been tapped to fund the settlements, both would still have been significantly under-insured. We believe that this was a key factor in the settlement dynamics of both claims.

4. Bankruptcy (Changes Everything)

Both WorldCom and Enron had filed for bankruptcy prior to the claim settlements (WorldCom has already exited and emerged as MCI). As may be typical in securities litigation involving bankrupt companies, the plaintiffs in these two cases changed their initial litigation strategy and either dropped or failed to name the company itself as a defendant. Such action may have been taken in order to avoid having the size of the settlement awards determined by the bankruptcy court, since bankruptcy courts have been notoriously unsympathetic to shareholder suits. This strategy either leaves the directors and officers as the sole defendants in the litigation or as the only "real" defendants, since the corporation may itself be somewhat judgment-proof due to the bankruptcy.

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5. Corporate Indemnification Obligations Wiped Out

While the companies were in bankruptcy, the individual insured defendants faced limitations in calling upon their corporate indemnification. This was especially true for claims brought prior to the bankruptcy filings because expenses involving pre-petition obligations are most often subordinate to both secured claims and post-petition (post-bankruptcy filing) debts and obligations.

By the time a company emerges from bankruptcy, the obligation of the "previous" company to indemnify its executives has most likely been extinguished. When the WorldCom independent directors announced their settlement, all of the company's indemnification obligations had already been terminated at its emergence from bankruptcy. MCI, as the ongoing company, is a separate legal entity from WorldCom and has no obligation to indemnify any past director, officer or employee of the predecessor entity. This means that these directors have no recourse under any theory of indemnification, whether mandatory or permissive. All claims against them, therefore, become A-Side claims, or non-indemnifiable in D&O terminology

6. Rescission

Prior to the settlements, how were the carriers responding to these claims? In these massive, documented cases of fraud, the carriers sought to rescind their policies based on the fraudulent company financials that had been publicly-filed and/or supplied to them as part of the normal underwriting process. It is public information that, in the case of WorldCom, the parties agreed, with the blessing of the bankruptcy court, to reform or re-write the D&O contract on both the primary and top excess layer to convert it to a dedicated A-Side program for non-indemnifiable claims. Notwithstanding this development, the remaining excess insurers continued to press their rescission claims up to the time of the settlement. By agreeing to pay a combined $36 million toward the settlement, the excess carriers forfeited their right to pursue rescission in an effort to take advantage of an attractive settlement opportunity presented by the plaintiff shareholders, avoid the risk and cost of rescission litigation, and stem the tide of defense costs which were running in the millions of dollars each month. Were the carriers opposed to having the individual directors themselves fund one-third of the proposed settlement? Not likely. But note that the contributions by these individuals did not themselves serve to reduce the obligations of the carriers.

Definitions:

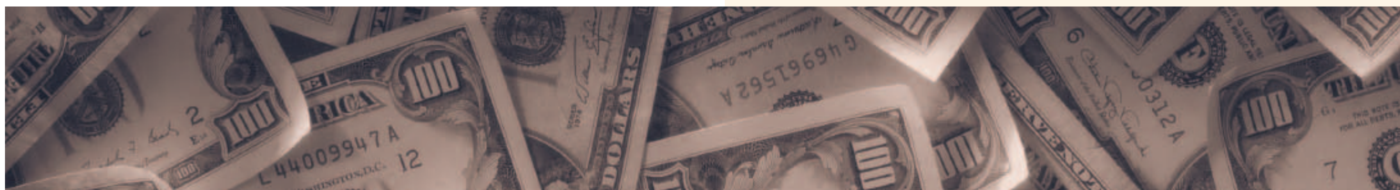
A-Side: Most D&O policies include "Side A" or coverage for non-indemnifiable loss, protecting the individual directors and officers in the event that a claim is made against them and that the company they serve is financially unable or legally precluded from providing protection.

B-Side: Most D&O policies also include "Side B" or indemnifiable loss coverage for the individual executives.

C-Side: Many D&O policies include "Side C" or coverage for the company itself (also referred to as "entity coverage"). For publicly-traded companies, entity coverage only extends to securities claims. For private companies, entity coverage is usually more expansive, providing broader balance sheet protection.

Rescission: If information submitted to the insurer during the underwriting process is false, the insurer's primary remedy is potential rescission of some or all coverage under the policy. If successful, such rescission voids the coverage "from the beginning"; coverage is deemed to never have existed, and the insurer is required to return the premium. The elements of a rescission case based on fraud vary from state to state but usually require the insurer to show that the insured made material misrepresentations regarding the risk being insured and that, but for the misrepresentations, the insurer would not have issued the policy.

Severability: The application severability clause determines in large part the extent to which coverage for a director or officer may be jeopardized by false information in the application. Generally, courts have held that absent specific language, a representation by one insured in the application can void the policy as to all insureds, including those who had no knowledge of the misrepresentation or the facts that were not properly disclosed. In order to avoid or minimize such a harsh result, many D&O policies contain an application severability provision which is intended to preserve coverage for innocent insureds.



Other Coverage Concerns

In at least one of these two cases, another substantial coverage issue arose relating to what would be covered as Loss under the typical D&O policy: the value of the stock options paid to the outside directors for services rendered pre-financial implosion was examined and considered by at least one carrier as a potential claim for disgorgement. If made part of a settlement, such amounts would not likely be covered by D&O insurance.

Final Thoughts

One wonders whether individual payments by outside directors signify a trend. The carriers involved in these claims are split on this issue. Still, all agree that when most or all of the above-referenced factors are present, we are likely to see a similar outcome.

At least from the perspective of disgorgement, it appears that personal payments by individuals will be a trend as SOX now specifically requires the repayment of certain executive compensation by the CEO and CFO in instances of fraud.

Lessons

(1) Non-rescindable contracts can be valuable. Available now on a limited basis in the D&O insurance market, they remove one of the key factors from the equation. Generally, they are available only as part of A-Side policies covering strictly non-indemnifiable risk of directors and officers.

Where a non-rescindable contract is not available, severability as to the application for insurance relative to the insured executives may be of some assistance in partially addressing the possible rescission of a D&O policy (although this would not have changed the outcome in either the WorldCom or Enron settlements).

(2) Higher limits of coverage, depending on the circumstances, may make a difference by addressing the issue of being under-insured. In these cases, the individual outside directors, with nowhere else to look for payment but themselves, facing serious liability claims, and with the complete erosion of the D&O coverage a virtual certainty, settled the plaintiffs' claims in order to avoid the enormous personal risk associated with such claims.

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