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CREDIT CRUNCH, BANKRUPTCY AND "SIDE A" DIRECTORS' & OFFICERS' LIABILITY COVERAGE

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The present economic environment could have many far-reaching effects on D&O coverage, many of which may be unanticipated. We have all seen the news that D&O insurers have already experienced large losses related to the subprime mortgage crisis. In the future, losses are expected to grow. The mortgage crisis is large and affects many ancillary industries. In addition to the traditional real estate related businesses, such as contractors and material supplies, the pervasive nature of mortgage-backed securities has caused claims to strike seemingly unrelated companies. Airlines, insurance companies, pension funds and even companies with previously large cash reserves are suffering. A separate, but related issue is the potential D&O losses that the tightening availability of credit and the looming recession could cause. On March 13, 2008, for instance, creditors began taking possession of Carlyle Capital's assets because the company was unable to refinance $16 billion in loans. Meanwhile, retailer Sharper Image Corp. started Chapter 11 proceedings a month earlier. The credit crisis is not only affecting leveraged start-ups, it is hitting both large and small well-established companies across many industries. If the business partners of credit requiring companies and companies like them fail, we could very well be facing a domino effect, which could have far-reaching consequences.

According to the American Bankruptcy Institute, there were 20,152 business bankruptcy filings in the first three quarters of 2007. That is more than the total number of filings for all of 2006. It has been reported that numerous law firms are increasing the number of bankruptcy lawyers on staff. Clearly they expect to see an increase in bankruptcy business down the road. This anticipated barrage of bankruptcies may not be just a passing phase, but rather a growing business trend. What we are seeing now may be the beginning of a wave that has just started to gain momentum.

According to past Towers Perrin D&O surveys, firms that are involved in mergers or acquisitions ("M&A"s) were more than twice as likely to have a claim against their directors and officers. (2001 & 2003). If credit was used to finance the M&A, then a tightening credit market could portend future claims as it becomes harder to refinance debt obligations. Additionally, companies with a narrow customer base are more susceptible to a recession. A company can be thought of as a stool with revenue sources as its legs. If the stool has four legs and one gets knocked out, it can still stand. However, if it starts with only three legs, then the removal of one becomes critical. Thus, insurance agents and brokers need to help evaluate the specific exposure profile for companies with the risk manager, directors and officers, and counsel.

The best defense to potential suits is good proactive management with consistent, well-formulated, well-documented and strategic operational policies. Involved board members, and effective corporate governance will all help to minimize D&O litigation expenses, including those arising out of bankruptcy. However, to protect against unforeseen business risks, a well-crafted D&O liability policy is a mandatory backstop. For individual directors and officers, the D&O policy is often the last firewall between a costly lawsuit and attacks upon their personal assets.

Most D&O policies are constructed with three parts: "Side A" (non-indemnifiable); "Side B" (corporate reimbursement); and "Side C" (entity coverage). "Side A" usually applies in three situations. First, "Side A" protects D&O's when the entity is legally unable to indemnify the D&O's because of the company's bylaws, or because of relevant statute (e.g. reimbursement is against public policy). Secondly, "Side A" applies in derivative suits which are brought by shareholders on the company's behalf. Oftentimes it is a conflict for a company to reimburse its D&O's in this case. However, in rare

circumstances, such as in Minnesota, derivative actions can be indemnified. Thirdly, "Side A" steps in when the company is financially unable to indemnify the D&O's due to bankruptcy or insolvency.

In the event of insolvency, the entity is no longer able to indemnify the individual directors and officers for their legal fees and losses incurred during litigation. For those individual directors and officers, the loss of indemnification from the entity is often catastrophic. The situation becomes even worse if the entity files bankruptcy. Bankruptcy Code 11 USC §§ 101 forbids a filing entity from paying any debt that arose prior to the petition. In other words, this provision prohibits the entity from indemnifying its directors and officers after bankruptcy has been filed. Thus the personal assets of the D&O's are exposed, not only for any liability, but also for incurred defense costs that arose before the filing of bankruptcy. Defense costs in these cases can be quite steep. A CEO could possibly lose his/her personal savings, investment portfolio, and even his/her house to pay legal fees and potential settlement or judgment.

In order to shield D&O's against such financially crippling hazards, agents need to be aware of several important "Side A" characteristics. First, "Side A" should be non-rescindable to fully provide the security the coverage requires. Second, the policy should contain a full severability of warranties to protect the innocent D&O's in the event of misstatements or misrepresentations in the application process. Third, the coverage should establish an order of payments. The reason for the need for an order of payments is because during bankruptcy, the D&O policy is viewed as an asset of the company. The bankruptcy trustee, creditors and shareholders will each try to gain access to the limits of liability. The worst scenario for a former officer or director is to see the policy's limits exhausted before the litigation is resolved (e.g. Enron). An order of payments provision states that the policy will allocate the coverage to losses covered under "Side A" before paying losses under "Side B" and "Side C."

For most private companies, D&O policies are often written on a "Duty to Defend" basis. Under a "Duty to Defend" policy, the insurer has the obligation ("right and duty") of assigning counsel to defend any claim. Consequently, defense costs are covered upfront by the insurer. Public company D&O policies, however, are "Non-Duty to Defend" or "Indemnity" policies which means that the insured has the responsibility to defend any claims. The indemnification nature of this provision requires the insured to pay the cost of defense out-of-pocket. Accordingly, "Non-Duty to Defend" policies should stipulate that the insurer will reimburse such costs on a prompt basis so that the individual D&O's are not advancing these expenses for long.

Primary "Side A only" policies are available to protect directors in the event the company does not purchase full D&O. Although not usually a recommended product, a primary "Side A only" policy can be useful for independent directors.

Excess "Side A only" coverage has become a more popular product in recent years. Towers Perrin's "Directors and Officers Liability 2006 Survey of Insurance Purchasing and Claims Trends" notes that the percentage of repeat survey participants purchasing "Side A only" coverage increased from 8% in 2005 to 15% in 2006. It goes on to say that 14% of all participants reported purchasing a "Side A only" policy. The number increases to 38% for public companies. In fact, the survey reports that 4% of respondents only purchase "Side A only" policies. This is an encouraging sign that more insurance professionals and corporate decision makers are recognizing the protection afforded under "Side A only" policies. By the same token though, it shows how underutilized the policies are, particularly for private companies.

Excess "Side A only" policies can be a straight excess policy or it can be an excess difference in conditions (DIC) policy. A straight excess "Side A only" provides excess limits when the underlying policies are exhausted by defense costs and/or settlements/judgments. An excess "Side A" DIC policy has the added benefit that it "drops down" when an exclusion or other coverage limitation in the underlying form(s) applies. The nature of "Side A only" policies prevent any uncertainty in coverage caused by bankruptcy (e.g. is the policy an asset of the bankruptcy estate or D&O's), exclusions (e.g. financial restatements), non-severability of warranties (e.g. fraudulent statements on the app), and potential policy rescission.

As the credit contraction puts more stress on companies, the exposure to individual directors and officers, particularly from insolvency/bankruptcy, increases. Fortunately, there is protection available. A well-crafted D&O policy, and excess "Side A only" coverage can offer a means of reducing exposure for directors and officers. Brokers and agents should discuss this coverage with their clients. Directors, officers, and risk managers should ask their insurance professionals and counsel about the pros and cons of their company's D&O policy and how it protects them.

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