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D&O LIABILITY: NOW IT'S PERSONAL

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D&O Liability: Now It's Personal

Although claims against directors and officers have received much attention over the last 25 years, in reality they historically have not implicated the personal assets of the defendant directors and officers. In virtually all cases, either the D&O insurer or the corporation paid the losses incurred by the defendant directors and officers. The officer defendants were forced to personally pay very rarely (i.e., only when insurance coverage and corporate indemnification were unavailable and the alleged wrongdoing was quite egregious). Outside directors were never required to pay a settlement out of their personal assets.

Unfortunately, in today's post-Enron environment, directors and officers can no longer feel safe from threats of personal liability exposure, even under the most protective insurance program. As evidenced by the recent Enron outside director settlement and the negotiation of the WorldCom outside director settlement, institutional lead plaintiffs, as well as regulators, are demanding unprecedented personal contributions to settle certain large D&O claims. In some instances, lead plaintiffs are refusing to settle with the directors and officers at any price (thus exposing the defendants to the risk of a catastrophic judgment and loss of insurance coverage) due to the unintended consequences of litigation reform legislation. In other cases, lead plaintiffs are settling with only some of the D&O defendants for the entire amount of the available insurance, thereby leaving the remaining D&O defendants uninsured. When combined with the well-publicized explosion in the size of D&O settlements in recent years, these developments are very alarming even for the most cynical director or officer.

The background and effect of the Enron outside director settlement and the proposed WorldCom outside director settlement are discussed below, as well as certain equally disturbing conduct by regulators.

A. Enron Settlement – Personal Contributions

The former outside directors of Enron recently agreed to settle securities class action claims against them by paying personally a total of \$13 million, which was in addition to \$168 million from the company's D&O insurance program. The personal contributions of the outside directors represent a portion of the profit realized by the directors on sales of company stock during the period preceding Enron's sudden financial collapse.

Much has been written about these unprecedented personal payments by the former outside directors of Enron, who admittedly were not direct participants in the activities causing Enron's demise. However, equally alarming but not well publicized is the consequence of that settlement on the other officer defendants in the Enron litigation, none of whom were included in the settlement. The settlement will exhaust the remaining available limits under the Enron D&O insurance program (except for a modest amount set aside for future defense costs of the non-settling officers). In other words, the non-settling officer defendants essentially will lose the

benefit of the remaining D&O insurance program because the outside directors used that insurance for their own settlement.

The D&O insurers of Enron were put in a classic Catch-22 by this partial settlement. The outside directors demanded the insurers pay the remaining limits to settle claims against them, but the non-settling officers demanded the insurers preserve the remaining limits for the protection of those non-settling officers. The insurers responded by filing an interpleader lawsuit with the court, which requires the court to decide which insureds should have access to the insurance proceeds. Not surprisingly, the court supported the proposed settlement and at least preliminarily approved the allocation of the insurance proceeds to the settlement, thereby leaving the officer defendants effectively uninsured.

Thus, the Enron settlement is startling not only because it requires significant personal contributions from the outside directors, but also because it eliminates coverage for any future settlement by or judgment against the officer defendants. The notion that some insureds can consume all of the D&O insurance proceeds to the detriment of other insureds is a shocking revelation to many directors and officers. A variety of uncontrollable dynamics can create this result, and thus directors and officers should consider this risk when structuring their D&O insurance program.

For example, a Side-A Independent Director Liability (“IDL”) Policy, which only covers non-indemnified loss of outside directors, can be purchased excess of a company’s standard D&O insurance program and can assure the outside directors that the company and its officers cannot take away from the directors at least the amount of coverage under the IDL Policy. Conceivably, a similar officer-only Side-A Policy could also be purchased, although such a Policy is not currently promoted by any D&O insurer. Such a policy would insure only officers, and thus prevent the outside directors from consuming all of the available insurance to the detriment of the officers.

B. WorldCom Settlement – D&Os as Pawns

The former directors and some officers of WorldCom tried to settle the securities class action claims against them in a highly publicized proposal announced in January 2005. Pursuant to that proposal, the former outside directors would pay a total of \$18 million and the WorldCom D&O insurers would pay \$36 million, plus a modest amount for future defense costs of the settling defendants in various independent actions. This proposed settlement would have been much more painful to the settling outside directors than the Enron settlement, where the outside directors merely disgorged a portion of their trading profits. The proposed WorldCom settlement amount represented approximately 20% of the outside directors’ personal net worth excluding residence and retirement accounts.

This very aggressive and unprecedented pursuit of outside directors reflects a regulator-type attitude by the lead plaintiff in the WorldCom litigation—the New York State Common Retirement Fund. In disclosing the proposed settlement, the Trustee for the Fund acknowledged that the WorldCom outside directors were being used to send a sobering message to all directors of public companies:

The fact that we have achieved a settlement in which these former outside directors have agreed to pay 20 percent of their cumulative personal net worth sends a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent. We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud.¹

This proposed settlement was terminated as a result of objections to some of the settlement terms by the non-settling co-defendant securities underwriters. However, ultimately a settlement was reached in which the outside directors contributed \$20.25 million of personal funds and insurance contributed \$35 million, for a total settlement of \$55.25 million by the outside directors.² But even though a settlement ultimately was reached, the basis for the objections to the proposed settlement, and the consequences to the D&O defendants, is even more alarming than the personal contributions to the settlement.

By way of background, the Reform Act adopted a proportionate liability concept under Section 10(b) of the Securities Exchange Act of 1934 and, with respect to outside directors, under Section 11 of the Securities Act of 1933. As a result, defendants in a Section 10(b) securities class action and outside directors in a Section 11 securities class action are now liable only for their proportionate share of plaintiffs' damages, based on each defendant's relative responsibility or fault. Directors and officers typically have the largest relative fault when compared to third party defendants such as accounting firms, law firms, underwriters and banks. However, those third party defendants may have the "deepest pocket" for recoveries by plaintiffs. In most situations, plaintiffs must be careful not to artificially limit their recovery from these deep pocket third party defendants by settling with the D&O defendants for an amount far less than the desired recovery from the third party defendants.

This in part explains why the Enron plaintiffs settled only with the outside directors and not with various officer defendants. The Section 10(b) claims against the Enron outside directors had been dismissed by the Court, and only claims under Section 11 of the Securities Act of 1933 remained.³ Because plaintiffs are targeting the co-defendant banks for the largest recoveries and because those banks are not defendants in the Section 11 claims, the Enron plaintiffs could settle the Section 11 claims against the outside directors without jeopardizing the amount of their recovery against the banks. But the plaintiffs refused to settle with the Enron officer defendants who were defendants in the Section 10(b) claims because plaintiffs feared such a settlement would jeopardize their claims against the co-defendant banks in light of the Reform Act's proportionate liability provision.

In WorldCom, though, plaintiffs are targeting securities underwriters for large recoveries. Those securities underwriters are co-defendants with the outside directors in the Section 11 claims. As a result, the proportionate liability provision was a huge concern for plaintiffs when structuring a settlement with just the outside directors and not the securities underwriters.

The WorldCom plaintiffs sought to avoid a limitation on their future recoveries from the underwriter defendants by including a provision in the settlement that reduced the non-settling underwriters' future liability only by the settling directors' theoretical ability to pay rather than

the settling directors' proportionate liability. The non-settling underwriters objected to that provision, and the court agreed that the provision was in violation of the Reform Act's proportionate liability provision.⁴ Without assurance that the director settlement would not limit a future settlement with the underwriters, the plaintiffs were forced to terminate the proposed director settlement.

The practical effect of that result was that the plaintiffs were unable to settle with the defendant directors unless and until plaintiffs settled with the underwriters. In other words, in cases like WorldCom, helpless D&O defendants may be held hostage to the settlement positions of their codefendants. If those codefendants choose not to settle, the defendant D&Os will be unable to settle and will be forced to defend themselves at trial, thereby running the risk of a catastrophic judgment. And, as a result of the Sarbanes-Oxley Act, such a judgment would not be dischargeable even if the defendant director or officer filed personal bankruptcy. In addition, there is a good chance an adverse judgment at trial would trigger the fraud exclusion in the D&O policy and will disqualify the defendant D&O from any available indemnification from the company. In other words, the defendant D&O may have no financial protection for the judgment. As the court in WorldCom candidly recognized in rejecting the proposed settlement provision:

Although enforcing the terms of the [proportionate liability statute] will make it extraordinarily difficult for outside directors to settle Section 11 claims before all deep-pocket defendants facing joint and several liability have done so, the [proposed settlement provision] must be rejected as inconsistent with the plain language of the statute as it applies to settlement of both Exchange Act claims and Section 11 claims involving outside directors. Thus, perhaps perversely, the statute does not protect the interests of outside directors to the extent that may have been intended by the drafters....Such [a result] may deserve to be remedied, but because the statutory language is clear, the remedy must be legislative.⁵

This “perversion” will likely occur in the future only in highly publicized large corporate failures where company assets and insurance proceeds are woefully inadequate to reimburse injured plaintiffs and where viable claims against deep pocket third parties exist. Although not likely to be frequent, even the remote risk of such a result should be truly frightening to outside directors. Unfortunately, little if anything can be done to avoid this result in light of the current law on proportionate liability.

C. Regulator Settlements – More Personal Contributions

Regulators are also sending a sobering message to directors and officers that their personal assets are very much at risk by reason of their corporate service. The SEC and some state regulators have recently begun an alarming trend of requiring, as a condition to settling claims against directors, officers and others, that the settling party agree not to seek or accept indemnification or reimbursement from any source (including the D&O insurance policy) for any amount paid in settlement of the claims by the regulator. In other words, the defendant director or officer is required to give up any rights to coverage for the settlement amount and is required

to personally pay the settlement amount without any indemnification or insurance protection, even though insurance and indemnification may otherwise be available.

This antagonism towards financial protection for target defendants was explained by current SEC Chairman William H. Donaldson on June 5, 2003 in a speech to the New York Financial Writers Association. In discussing the SEC's enforcement actions and strategies, he stated:

I'm concerned about companies that, under permissive state laws, indemnify their officers and directors against disgorgement and penalties ordered in law enforcement actions, including those brought by the Commission. In my mind, this just isn't good public policy. This is an area in which we may need to consider ways to bring about reform.⁶

The Chairman's statement appears to have been in response to Xerox Corporation's disclosure that it would indemnify six of its former officers for \$19 million out of \$22 million in fines, penalties and disgorgement assessed by the SEC in the settlement of an enforcement action.

The prohibition on indemnification or insurance reimbursement in the enforcement context was a prominent part of the SEC's settlement of the research analyst conflict of interest cases in mid-2003. The settlement included payments into a Distribution Fund for the benefit of investors, and each of the consent agreements with the 10 settling broker-dealers included the following language:

Defendant agrees that it shall not seek or accept, directly or indirectly, reimbursement or indemnification, including but not limited to payment made pursuant to any insurance policy, with regard to the penalty amounts that Defendants shall pay pursuant to Section II of the Final Judgment, regardless of whether such penalty amounts or any part thereof are added to the Distribution Fund Account or otherwise used for the benefit of investors.⁷

Significantly, the SEC also included this same language in settlements with the individual analyst defendants Henry Blodget⁸ and Jack Grubman.⁹ Assuming that indemnification or reimbursement was otherwise available to Blodget and Grubman, the prohibition on indemnification prevented their employers from indemnifying them, and the prohibition on insurance reimbursement prevented Blodget and Grubman from seeking coverage under their D&O and E&O policies.

This practice by the SEC gained momentum in the May 2004 agreements to settle the SEC's civil enforcement action against Lucent Technologies, Inc. and certain former officers/employees.¹⁰ Like in the settlements of the analyst conflict of interest cases, in settling the SEC charges Lucent and the three settling individual defendants agreed not to seek or accept, directly or indirectly, reimbursement or indemnification from any source, including but not

limited to payment made pursuant to any insurance policy, with regard to any civil penalty amounts paid by them.

Perhaps the most notable aspect of the Lucent settlement, however, was the SEC's criticism of Lucent's decision to expand the scope of employees eligible for indemnification in respect of SEC enforcement actions. Lucent had decided to advance defense costs to employees who did not settle with the SEC, and who were not the subject of preexisting indemnification or advancement agreements. Reportedly, the SEC viewed this action as handing those employees "a blank check to litigate with [the SEC], with no consequences." The SEC considered this indemnification decision to be a failure to cooperate, and imposed a \$25 million fine on Lucent for this decision, as well as several other instances of conduct that the SEC deemed to be a "lack of cooperation." No fine had been contemplated under the initial agreement in principle to settle the case.

The Lucent settlement demonstrates that in addition to precluding indemnification and insurance reimbursement for settlement amounts, the SEC is now also reviewing indemnification practices, including advancement of defense costs, especially in the face of an SEC enforcement action.

State authorities are similarly seeking to prohibit or limit indemnification and insurance reimbursement when settling enforcement actions. For example, the Massachusetts Secretary of the Commonwealth¹¹ and the New York Attorney General¹² have recently prohibited or limited indemnification and insurance reimbursement when settling investigations into alleged improprieties in the mutual fund industry.

Since fines and penalties are typically excluded from coverage under a D&O policy in any event, the regulator's prohibition against insurance reimbursement may appear to be merely a theoretical prohibition. However, two types of loss which usually are covered are subject to this prohibition. First, defense costs in connection with a claim seeking fines or penalties typically are covered, but may become subject to a regulator's reimbursement prohibition. Second, many settlements with regulators are structured not as a fine or penalty, but as payment of compensatory damages to a fund that is distributed to parties injured by the alleged wrongdoing. Such a compensatory damage settlement with a regulator typically would be covered, but may become subject to the regulator's reimbursement prohibition.

D. Conclusions

Yogi Berra observed that "the future ain't what it used to be." That is certainly true for directors and officers. They are now being held to more demanding standards of conduct, they are being scrutinized more than ever before, and when perceived wrongdoing occurs, they are being pursued by shareholders and regulators with frightening aggression. The SEC enforcement director recently explained the justification for this hostile environment as follows:

There's nothing more important from our perspective in what we do than trying to hold accountable individuals. We think it's important to punish both individual and corporate wrongdoers. Effective deterrence requires personal accountability.¹³

Only time will tell whether these developments will be limited to a small handful of gigantic corporate debacles or will be expanded into more “routine” D&O claims situations. Whatever happens, though, it is clear that particularly outside directors are now more concerned about their financial exposure than ever before and are demanding more scrutiny of their insurance and indemnification programs to assure the maximum protection will be available to them. As a result, the D&O insurance product is now elevated to a far more important role in corporate America. Unless that product is perceived as affording comprehensive and predictable personal asset protection for outside directors, fewer qualified directors will agree to serve and the quality of corporate governance will suffer.

Although no insurance policy can provide absolute protection against any possible claim scenario, a broad form Side-A D&O policy (which only insures D&O losses that are not indemnified by the company) affords high quality personal asset protection for directors and officers both because of the Policy’s very broad terms and because the coverage is not diluted by coverage for the company.

From the standpoint of just the outside directors, the most protective insurance product is an IDL Policy, which is an extraordinarily broad Side-A policy insuring only the outside directors for non-indemnified loss. For example, the IDL Policies that afford the broadest coverage contain all of the coverage enhancements contained in the standard Side-A Policy, plus no exclusions for fraud, dishonesty, willful violations of law or illegal remuneration. In addition, by insuring only the outside directors, coverage under the Policy is not diluted by losses incurred by officers or the company.

Absent this type of extraordinary and reliable insurance protection, corporations may find it harder and harder to recruit and retain qualified outside directors in today’s increasingly hostile litigation environment.

¹ New York State Comptroller News Release, “Hevesi Announces Historic Settlement, Former WorldCom Directors to Pay From Own Pockets” (Jan. 7, 2005).

² In addition, former WorldCom Chairman Bert Roberts subsequently agreed to pay a total of \$4.5 million from his own pocket to settle the claims against him, bringing the total settlement with directors to \$60.75. Also, Bernie Ebbers agreed to transfer virtually all of his personal assets towards the settlement, representing an additional \$30 million to \$45 million settlement contribution.

³ *In re Enron Corp. Securities, Derivative and ERISA Litigation*, 258 F. Supp. 2d 576 (S.D. Tex. 2003).

⁴ *In re WorldCom, Inc. Securities Litigation*, 2005 U.S. Dist. LEXIS 1805 (Feb. 9, 2005).

⁵ *Id.*, slip op. at 33.

⁶ Donaldson, “Remarks Before the New York Financial Writers Association” (June 5, 2003).

⁷ *See, e.g.* Securities and Exchange Commission Litigation Release No. 18115 (April 28, 2003).

⁸ Consent of Defendant Henry McKelvey Blodget, Case No. 03-CV-2947 (S.D.N.Y.).

⁹ Consent of Defendant Jack Benjamin Grubman, Case No. 03-CV-2938 (S.D.N.Y.).

¹⁰ Securities and Exchange Commission Litigation Release No. 18715 (May 17, 2004).

¹¹ *In the Matter of Putnam Investment Management LLC*, Docket No. E-2003-061 (April 8, 2004).

¹² *In the Matter of Janus Capital Management, LLC*, Assurance of Discontinuance Pursuant to Executive Law 63(15) (August 9, 2004).

¹³ “Your Fault: Directors’ Payback Deal Shows Corporate Boards Aren’t Safe,” *Wall Street Journal*, Jan.7, 2005, p. C1.