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## **Protecting Director Assets In Troubled Times**

*Why director liability coverage needs to outlive the company itself.*

by Sheon Karol and David Finz

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MARCH/APRIL 2010

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Vol. XXXI

Recycled  Paper

No. 181

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**Subscriptions:** Available to corporations at an annual cost of \$3,000. This provides delivery of six bimonthly issues to each board member, senior legal and financial officers, and the corporate secretary. Periodicals postage rates have been paid at Okemos, MI and at additional mailing offices.

**POSTMASTER:** Send changes and all subscription correspondence with THE CORPORATE BOARD mailing label to Customer Service, THE CORPORATE BOARD, Vanguard Publications, 4440 Hagadorn Rd., Okemos, Michigan 48864, (517) 336-1700.

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# Protecting Director Assets In Troubled Times

by Sheon Karol and David Finz

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Two years of economic turmoil have led some companies to extreme survival measures, including bankruptcy, mergers and major restructurings. Hard times not only endanger companies, but their directors and officers as well. Liability threats increase, often at the same moment a major corporate change puts board members' insurance coverage in peril. What can directors do to protect themselves while protecting the company?

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Board members and senior executives of companies that are facing litigation or enforcement proceedings not only face the challenges of leading their distressed firms through the storm. There is also the possibility of significant personal financial liability as a result of shareholder litigation.

**With many companies affected by the credit crisis and in financial distress, directors have reason for concern about their ability to pay liability claims.**

In 2008, federal securities class action filings hit a five-year high, according to a report from NERA Economic Consulting. NERA also projected that final filing figures in 2009 would be as high as in 2008. The report found cases related to the credit crisis are driving the trend and accounted for more than 40 percent of filings reported through the first half of 2009. With many firms affected by the credit crisis and in financial distress, directors have reason for concern about their ability to pay claims.

Fortunately, however, directors and officers may gain protection through careful planning and effective risk management. These measures call for understanding the broad and complex risks associated with restructuring and the insurance available

to address them. It is well worth the effort by board members to understand the protection provided under the company's directors and officers (D&O) liability insurance, and to be familiar with key coverage options and enhancements.

Several factors have contributed to the challenging environment for distressed businesses. For public companies, investor losses have led to stepped-up enforcement by the Securities and Exchange Commission, as well as to a rise in allegations that board members breached their fiduciary duties to shareholders (and even bondholders) by mismanaging corporate assets.

To resolve their firms' difficulties, leaders of distressed companies often pursue transactions, such as mergers, acquisitions, or divestitures. They may choose (or be forced) to file Chapter 11. While this may help a company get out of the woods, transactional solutions are no walk in the park. Potential dangers include:

*Pending or threatened litigation.* The specter of a lawsuit can hang like a dark cloud over a merger or acquisition. In some cases, other parties to the transaction may become reluctant to close on the deal. At the very least, concerns about litigation can depress the market value of the company seeking to be acquired, or make it more difficult to obtain the financing needed to complete the deal.

*Tax treatment of the transaction.* Those buying up distressed companies or their assets increasingly seek assurance that a legal opinion supporting a particular tax treatment of the transaction will not face later challenge.

*Representations and warranties around the*

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*transaction.* In the case of a divestiture, inaccurate statements made by the seller about the target company can create a liability that may haunt parties long after a deal is consummated. Buyers may seek to recover losses, claiming an inaccurate financial representation or warranty.

□ *Other contingent liabilities.* Some transactions may have specific, unique risks or complexities associated with them. For instance, some mergers might require regulatory approval. Others may be subject to challenge on the basis of antitrust laws. Often, an enterprise's value is based on a projected future revenue stream. However, when a company's revenue depends on a single source, such as government contracts, its financial picture can change in an instant. Regardless, if a merger or acquisition fails to close, the seller may be required to pay a penalty.

While each of these situations may risk potential exposure for the corporation, they also may have implications for the individual directors who were involved in the transaction. Stakeholders may seek to hold them personally liable for any perceived errors in judgment or alleged misrepresentations that created liability for the company.

**If an insolvent company shares coverage limits with its individual directors, the company's erosion of coverage could leave directors underinsured.**

In bankruptcy, the trustees and creditors may assert that a company's D&O insurance policy belongs to the estate, thus placing any proceeds beyond the reach of the individuals they were designed to protect. Yet, even if trustees and creditors do not prevail on this point, there is another potential issue. If a D&O policy is structured so that a corporate entity shares the coverage with individual directors, the erosion of the policy's coverage limits by an insolvent company can leave the board members underinsured.

In the current economic environment, new directors of any businesses—and particularly of those in distress—will seek assurance that their D&O insurance coverage is “airtight.” Those joining

businesses that already have faced shareholder suits want to make sure that a second round of litigation (if it occurs) will not let insurers argue the alleged wrongful acts are “interrelated” to those that gave rise to the first round.

Some D&O policies stipulate that if alleged wrongful acts are “interrelated,” then claims triggered by these acts could be relegated to the prior D&O insurance policy. The coverage limits could then already be eroded. This would leave directors and officers with reduced protection and increased risk to their personal assets.

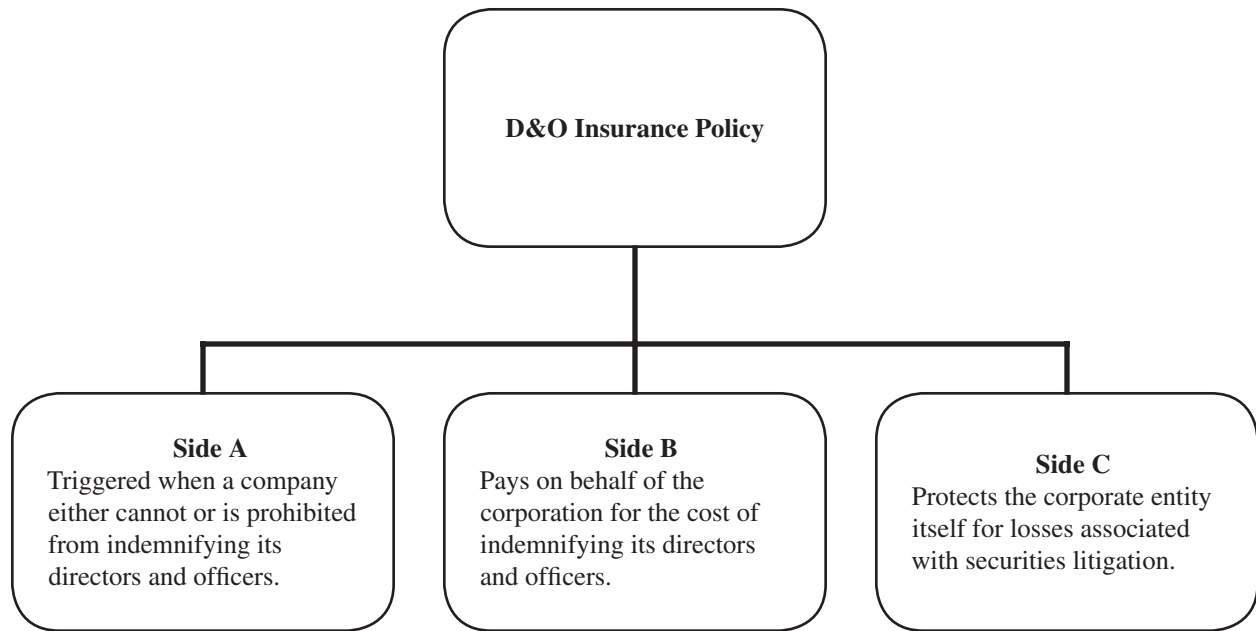
There is also the issue of the legal status of the “debtor-in-possession.” A debtor-in-possession is considered a legal entity, separate and apart from the distressed company. To ensure continuing coverage, the definition of an “insured” in a D&O policy should include a debtor-in-possession. If this is not part of the definition, then coverage will need to be arranged for the new entity. This is particularly important because directors of the distressed company may continue to serve on the board or in the C-suite of the debtor-in-possession after a Chapter 11 petition is filed.

Finally, with a number of insurance companies directly affected by the credit crisis and subprime investments, policyholders are increasingly concerned about insurer solvency. This adds yet another dimension of uncertainty to coverage for directors and officers. In the wake of the financial crisis of 2008, many risk managers and other purchasers of commercial insurance have become wary of the marketplace, given the difficulties that some insurers have faced with their financial stability.

In the case of “runoff” coverage, which often is purchased to protect directors and officers of companies involved in liquidation, the problem becomes particularly acute. These policies are typically offered for six-year terms, leaving the directors covered under it dependent on the long-term strength of the insurers providing the coverage.

The three broad categories of D&O insurance are commonly known as “Side A,” “Side B” and “Side C.” Here is a brief description of each coverage in reverse order:

**Learning Your ABC's**  
**One Policy, Three Coverages**



□ Side C coverage is designed to protect the corporate entity for losses associated with securities litigation against the company, including defense costs and damages from a settlement or judgment.

□ Side B coverage is designed to pay the company's legal defense of, and settlements or judgments involving, its directors and officers for actions taken in their official capacity (and in some cases, for their activities as outside directors) as promised under the corporate bylaws.

□ Side A coverage is designed to provide protection for directors and officers when a company either cannot or will not indemnify these individuals. However, if a company has the means and refuses to indemnify its directors and officers, the insurer may interpret the contract to presume that the company nevertheless has such an obligation. It then will not begin to pay on covered losses until the Side B retention is satisfied.

A variation of the D&O contract is coverage structured to be in excess of the Side A, B, C contracts, adding coverage for Side A only. This contract, which

is also known as a Difference In Conditions (DIC) policy, keeps insurance available to pay certain claims that are not indemnifiable. It can be structured to pay claims whose amounts exceed the limits provided under the ABC policies, or drop down and provide coverage for certain claims that are excluded or inadequately covered.

Another slight variation to the Side A contract is an Independent Directors Liability (IDL) contract. While also technically a Side A policy, this only covers independent directors as opposed to all directors and officers. These contracts are purchased by firms that are trying to attract outside directors, but have existing D&O insurance policies with impaired limits (due to claims filed under them). The newly dedicated coverage under the IDL policy is added to cover claims after the new director joins the board. Similar to Side A coverage, it only applies when the company cannot indemnify the director for financial or legal reasons.

Qualified insurance brokers who specialize in management liability can design insurance programs that

can offer various degrees of protection for distressed companies. Coverage can be customized for the board members and senior management, according to the scope of coverage desired. Here are some of the key coverage provisions to explore when a company is facing stress:

□ *Amending the “Insured vs. Insured” exclusion.* Be sure the policy has amendments to the exclusion for “Insured vs. Insured” claims, which otherwise could eliminate coverage for claims brought by bankruptcy trustees and creditor committees, as well as the debtor-in-possession.

This type of claim could arise during a Chapter 11 reorganization, when either the trustee, acting on behalf of the debtor-in-possession, or the bondholders pursue legal action against the company’s directors and officers. The problem created by the exclusion is that absent a carve-back, these plaintiffs could be considered “insureds” under the policy, which could exclude the claims from coverage.

**Look for policy provisions that trigger a “Change in Control” provision, which could void liability claims under the current policy.**

□ *Defining “Change in Control.”* Clarify the specific conditions that will trigger a “change in control” under the policy. For example, when a company emerges from Chapter 11, there is invariably some realignment among major shareholders and, consequently, a change in composition of the board.

Coverage should exempt these events from triggering the “change in control” provision in order to prevent the company’s ongoing D&O program from being voided for claims during the remainder of the policy based upon future wrongful acts. In addition, be sure to look for other circumstances that would trigger the change in control provision, depending on the structure of the transaction and other factors.

□ *Establishing “fresh” limits.* Distressed businesses may need to secure “fresh” limits on their D&O insurance policies, rather than an extension of existing limits. In many situations, the existing

limits may already be tapped, whether by claims or by notices of “circumstances” (potential claims) already provided to current insurers.

**Your insurance broker may need to help you tell the company’s turnaround story to the insurance marketplace, and position the “New Company” in the best possible light.**

Distressed companies often find the commercial insurance markets reluctant to quote coverage for new limits. Instead, insurers will offer an extension of the current insurance program for an additional premium. However, the limits may have already been compromised.

In these instances, the company’s insurance broker may need to help you tell the story of the company’s turnaround to the insurance marketplace, and position the “New Company’s” risk in the best possible light. Often, this approach requires putting the program out for competitive bids with new insurers that may be more receptive to the company’s turnaround.

□ *Extending the policy term.* Policyholders unable to secure fresh limits will need to seek an extension of the expiring policy period to cover new claims. This will require payment of an additional premium.

You also need to watch for specific litigation exclusions. Typically, this wording is added to the base policy, and states that the insurer shall not be liable for claims arising from a particular set of facts, which are known about by the parties at the time that coverage is extended.

Because subsequent claims made during this extension of the policy period will not be covered, it is important to report all claims—and to give notice of any circumstances that may result in a claim—before the negotiation for an extension is completed. Simply ignoring a potential source of litigation and hoping the matter will go away serves the interests of neither the company nor its board members.

□ *Post-liquidation protection.* Even after a company is liquidated, its former directors and officers still face the risk of being named in a lawsuit arising from their conduct while serving with the bankrupt

company. With the corporation gone, so is the source for indemnification on which they relied.

*Securing “runoff” coverage.* Be sure to also consider “runoff” coverage if the company is undergoing a complete liquidation under Chapter 7. If a company’s assets are being liquidated, then there will be no ongoing coverage for new claims that may arise out of the company’s troubled history.

Runoff coverage protects insureds for future claims for acts alleged to have occurred prior to the policy’s inception. This coverage is typically available for a term of six years. The rationale for this policy term is that it is the longest statute of limitations for tort claims in most jurisdictions.

Runoff coverage is typically priced at a low multiple of the former company’s annual D&O premium. As mentioned, however, in light of the policy’s longer term, it is vital to check the financial strength of the insurance company providing this coverage.

### **Severability provisions will help protect innocent insureds from the misdeeds of one “bad actor.”**

*Safeguarding innocent insureds.* Policies should include “severability” language to protect innocent insureds in case an insurer attempts to rescind coverage as a result of one “bad actor.” This is based on the principle that the misdeeds of one person (such as a CFO’s misrepresentations) should not be imputed to another, absent some clear evidence of wrongdoing. Severability may help encourage people to begin, or continue, serving on the board of a company, even when there has been a “crisis of confidence.”

*Checking “Order of Payments” provision.* This provision makes it more likely that payment will be triggered first to directors and officers when they must share the policy’s limits with a company involved in bankruptcy (although this may not be followed by the bankruptcy court). Without such a clause, the bankruptcy estate could easily consume all shared limits of the side A, B, and C coverages, leaving individual directors with far less to cover their own non-indemnifiable losses.

*Affirming insurer responsibility in bankruptcy.* The D&O policy should contain language that expressly guarantees that a bankruptcy filing by the corporation does not relieve an insurer of its obligations under the policy. Of course, the filing of a bankruptcy petition *per se* should not serve as a bar to coverage. Still, insurers may claim the bankruptcy was prompted, in whole or in part, by some other offense, such as fraud in the application or a breach of representations and warranties. This could serve as grounds for denying coverage.

*Advancing defense costs for insureds.* One critical coverage feature is the advancement of defense costs to insureds on an “as-incurred” basis, rather than at the conclusion of litigation. Without this language, the lack of immediate reimbursement for these legal expenses could force directors to settle, resulting in a less favorable settlement. In some situations, defense costs will be substantial, pushing them into bankruptcy—a situation D&O coverage is designed to prevent.

*Defining excess coverage triggers.* Although this provision will not provide much security for directors and officers in the event of a total liquidation, it addresses the issue of insurer insolvency. It would be unjust for the distressed company to have to spend its own funds to indemnify its directors, only to find that the insurance companies providing the excess layers of coverage on their D&O program refuse to recognize such payments as satisfying the underlying limits.

In the current legal and regulatory environment, directors of distressed companies must take steps to protect their personal assets in the event of litigation. Attending to these issues before a company becomes distressed may be the optimal course of action, but it is not always feasible.

As soon as a distressed company becomes aware that a Chapter 11 filing is imminent, or that a change in control provision may be triggered, it is imperative to contact insurance and restructuring professionals. Discuss both your coverage for past wrongful acts that may result in future claims, and also ongoing coverage for prospective conduct. ■

**The world may be known without  
leaving the house.**

*— Lao Tzu*