The Market Meltdown: Time to Reevaluate D&O Coverage

By Linda Dakin-Grimm

The continued fallout from the crisis in the financial markets should cause every director or officer of a public company to reevaluate available D&O insurance—at a level of detail that may previously have been left to the broker or insurance manager. Virtually every week of September and October 2008 saw dramatic news that should have caused directors and officers great concern about the protection available to them.

What Happened in the Fall, 2008?

On Sunday September 7, 2008, mortgage giants Fannie Mae and Freddie Mac were seized by the U.S. government. Lawsuits against directors and officers immediately ensued. *Less than 24 hours later,* the former law firm of Bill Lerach (who now resides in prison) filed a class action lawsuit in the U. S. District Court for the Southern District of New York against four former top Fannie Mae officers. The complaint alleges that certain of Fannie Mae's officers and/or directors violated the Securities Exchange Act of 1934, by making materially false and misleading statements about Fannie Mae's business, prospects, and the company's financial statements, while at the same time benefiting from generous compensation packages. The lawyers alleged that false and misleading statements caused Fannie Mae stock to trade at artificially inflated prices between November 16, 2007, and September 5, 2008, reaching as high as $40.69 per share, before it eventually plummeted dramatically. On September 8, 2008, the day after federal regulators announced the seizure, Fannie Mae's stock opened at $1.91 per share. According to the complaint, "because of their positions within the company and their access to material nonpublic information available to them alone, the individual defendants knew that the adverse facts specified herein had not been disclosed to and were being concealed from the public and that the positive representations being made were then materially false and misleading."

It is certainly not known if or how these allegations will be proven. Regardless of their merit, however, it will be extremely costly to defend the lawsuits, with counsel appointed for each defendant presumably funded by Fannie Mae's D&O liability insurers.

Director Summary: In the wake of the financial meltdown on Wall Street, there have been a number of lawsuits filed against directors of financial institutions and other companies, who invested shareholders' assets in risky mortgage-lending products. As a result, the cost of D&O insurance is likely to increase, and it is a prime time for directors to reevaluate their D&O policies.

Lehman Brothers

But September 2008 continued to be an unprecedented and historic month. The fate of investment bank Lehman Brothers, which had been in turmoil for months, finally came to a head, when its last-gasp efforts to find a buyer failed and it announced its bankruptcy filing on the evening of September 14th. Virtually simultaneously with the bankruptcy filing, the press began reporting comments alleging the lack of qualifications, inattention, and advanced age of certain Lehman board members. The limits of Lehman's D&O insurance program will undoubtedly become an important asset of its bankruptcy estate that will be hotly pursued by lawyers. On the same day that Lehman filed for bankruptcy, Merrill Lynch announced that it would be acquired by Bank of America—narrowly avoiding Lehman's fate. Directors and officers of both Lehman Brothers and Merrill Lynch almost certainly will face allegations that will implicate their D&O coverage.

AIG

During the week of September 8, 2008, attorneys for several former executives of American International Group Inc. (AIG), including former chief Maurice R. Greenberg, announced a

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$115 million settlement—$85 million of which was to be funded by D&O insurers—to resolve a several years' old shareholders' derivative lawsuit over commissions the insurer paid to companies controlled by Mr. Greenberg and other AIG officials.

But the announcement of that huge settlement was lost in the noise created by the crisis AIG itself faced in September, as a result of its financial products division's participation in credit default swaps that were hugely unprofitable for the company. On September 15th, in an effort to help AIG to avoid bankruptcy, the governor of New York announced an unprecedented waiver of state insurance laws to permit AIG to borrow $20 billion from its state-regulated subsidiaries. Before the details of that proposal could even be fully articulated (and the views of other states' insurance regulators obtained), it was announced that the Federal Reserve would lend AIG up to $85 billion, in exchange for an 80 percent ownership of the company. That amount has since been increased to more than $120 billion. It now appears that AIG will freeze executive compensation that had been contractually promised to a former CEO, and that no funds will be distributed out of the $600 million deferred compensation and bonus pools of AIG's financial products subsidiary that is at the center of the debacle.

And this astonishing event—the government takeover of one of the largest insurance conglomerates in the world—was soon dwarfed by the September 18th announcement that the U.S. government would create a new "facility"—referred to by some commentators as a "bad business garbage disposal" to buy up the bad mortgage debt, spending up to $700 billion to do so. The "bailout," as the press soon dubbed it, was initially rejected by Congress and created huge dissension in the public before it was ultimately passed by congress and signed into law. But it did not calm the tanking stock market, which by then had lost trillions of dollars in perceived value. Washington Mutual, one of the country's largest financial institutions, was gobbled up by JP Morgan/Chase on the eve of its own bankruptcy. Wachovia was acquired by Wells Fargo (which bested rival Citigroup to get the assets). On September 22, the last two standing investment banks—Goldman Sachs and Morgan Stanley—announced that they would adopt the bank holding company structure that would subject them to stricter regulation, less leverage, and probably lower returns, essentially ending the golden age of American investment banking.

The $700 billion "bailout" did not "fix" the frozen credit markets or the still-tanking stock market. Nor did it end the government intervention into the financial system. In mid-October, the United States, in conjunction with governments of European countries and Japan, jointly injected several hundred million dollars into the world's major banks, in an effort to unfreeze the capital markets and re-start bank lending.

Other Firms

In addition to Lehman Brothers and AIG, the list of entities that will likely face allegations of wrongdoing is increasing. Perhaps the only business that will thrive in the current environment is the business of suing directors and officers.

What Types of Lawsuits Are Being Filed?

Earlier in the year, borrower class actions against financial institutions and related loan service businesses (on behalf of homeowners/borrowers who faced or had experienced foreclosure) dominated the filings. These suits, which are chugging along in the early stages, allege various abuses in the mortgage lending business itself, including inadequate disclosures to borrowers of the nature and risk of loans, and discriminatory mortgage prices. Allegations against directors and officers typically concern breach of fiduciary duty and negligent supervision of the lending process.

Securities class actions constituted about a quarter of new federal court filings in the first part of 2008. These suits have not been limited to companies in the financial sector, but also are brought against companies (and their management) that invested shareholders' equity in risky (and now failing) mortgage lending-related securitized financial products, including collateralized debt obligations. These lawsuits (like the suit against Fannie Mae officers), focus on inflation and subsequent deflation of a target company's stock price, allegedly due to inaccurate/incomplete disclosures to stockholders about the stability of the company in a specific time period.

Shareholders' derivative claims, and ERISA actions by company-sponsored retirement plans that invested in poorly performing securities, have made up another quarter of recent filings. The majority of suits have been filed in New York and California.

What Will This Wave of Litigation Cost?

Estimates have varied widely over the past ten months. In December 2007, the insurance industry publication *National Underwriter* reported that figures from various experts on the potential insurance liability resulting from the sub-prime mortgage crisis ranged from $3 billion (for D&O insurance claims only) to $30 billion (including errors and ommissions claims). Industry experts have recently been more circumspect, but the situation has certainly not improved.

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What Should Directors and Officers Ask About Their D&O Coverage?

In the current economic climate, it is the rare director who can afford to trust that he or she has adequate insurance coverage that will provide protection when needed. Directors should ask the following questions of their brokers and insurance managers, and insist that policies be modified mid-term if the answers are not satisfactory:

(1) Does the company have sufficient limits to cover allegations against multiple directors in the catastrophic suit? In this regard, do defense costs—which can amount to tens of millions of dollars—erode the available policy limits for a claim? If so, directors cannot be confident that there will ultimately be insurance proceeds available to satisfy a claim against them.

In a series of interesting posts on his blog, the *D&O Diary,* industry commentator Kevin La Croix points to the bankruptcy of auto parts manufacturer Collins & Aikman as a cautionary tale. That entity had healthy D&O limits of $50 million "per occurrence." However, the numerous related proceedings against directors and officers completely exhausted the coverage, leaving individual directors without any insurance either to pay for their ongoing defense or ultimately to fund settlement or verdicts against them.

(2) Who decides how the "per occurrence" limits are apportioned between and among multiple directors facing claims? Under most D&O policies, one "per occurrence" limit applies to all insureds involved in the same event or series of events. This means that only one set of limits is available to all involved directors, and depending upon the policy language, the limits can be eroded by every director's defense costs and settlement. The determination and timing of how the limits are used up is crucial, for example, to the individual director sued last.

(3) Are former directors at risk of having their coverage eliminated retroactively? A 2008 decision from the Delaware Chancery Court, in *Schoon v. Troy Corporation,* held that a corporation was permitted retroactively to eliminate former directors' advancement rights. While the outcome of this case (now before the Delaware Supreme Court) is uncertain, the prudent director today will take steps to ensure continued access to insurance after the end of board service.

(4) Does the actual wording of your policy layers work together or, on the other hand, are the policies written in such a way as to make it likely that the "excess" layers will dispute their obligations? D&O insurance is typically purchased in layers, often from different companies, regardless of the descriptions of coverage provided to board members by the broker.

Problems arise when the excess policy wordings do not conform to the primary language or, where they do follow form, contain additional exclusions and definitions beyond what are contained in the primary policy. It is imperative that the insured and insurer clarify any ambiguities before a claim is presented. It is not prudent to assume that because the insurance program was procured (or described) by a broker, that the policies (and the insurers who sold them) will work together seamlessly.

(5) Is your "Side A" coverage clear and unambiguous? Many companies have purchased additional limits for their directors and officers of what is called Side A insurance—that is, insurance protection for liability and defense expenses that are not indemnifiable by the employer due either to legal prohibition or insolvency. These Side A covers often are not written clearly, and the precise circumstances in which they will respond often are left vague, enabling the insurers to dispute and/or delay advancement of expenses or payment of claims.

Given the astonishing events of the Fall of 2008, the time to review and evaluate the entire D&O program and all the policy wordings—not just the stated limits—is absolutely now. ■

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