Global Financial Restructuring

Client Alert

Global | Baker & McKenzie

12 December 2008

This information is intended to provide clients with information on recent legal developments and issues of significant interest. It should not be regarded as legal advice or opinion.

Our Global Financial Restructuring Team brings together an interdisciplinary team of lawyers with the combined experience needed to address and resolve the complex issues currently confronting clients. Through our extensive network of 68 offices worldwide, we provide expertise and seamless service to clients across multiple jurisdictions and practice areas including Financial Restructuring and Creditor's Rights, Purchase and Sale of Distressed Assets, Distressed Debt Trading, Derivatives, Structured Finance, Real Estate, Dispute Resolution, M&A, Post Acquisition Integration, Tax and Employment.

Our experienced lawyers have guided clients through the turbulent times over the last three decades, including the 1980s debt crisis in Latin America, the early 1990s debt crisis in the US and Europe and the 1997 Asian financial crisis.

For further information please contact the current Baker & McKenzie LLP attorney with whom you work, or any of the individuals listed below

Barrie Brejcha
North America, *Dispute Resolution*
Tel: +1 312 861 2782
barrie.l.brejcha@bakernet.com

Charles Dick
North America, *Dispute Resolution*
Tel: +1 858 523 6270
charles.h.dick@bakernet.com

Ronald Ohren
North America, *Dispute Resolution*
Tel: +1 312 861 8854
ronald.l.ohren@bakernet.com

Gary Seib
Asia Pacific, *Dispute Resolution*
Tel: +852 2846 2112
gary.seib@bakernet.com

Elizabeth Yingling
North America, *Dispute Resolution*
Tel: +1 214 978 3039
elizabeth.l.yingling@bakernet.com

www.bakernet.com

This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.

Independent Directors Require Additional Protection in Financial Crisis Litigation

The recent spate of financial crisis-related litigation, on the heels of a variety of high exposure shareholder class actions charging management misconduct, confirm that independent directors may require protection beyond standard directors & officers (D&O) liability insurance coverage. Settlements by the outside directors of WorldCom and Enron—among others in the wave of corporate scandals—highlight the fact that directors now face unprecedented danger and may be uninsured for a claim, or at least underinsured in light of the other amounts that substantially erode policy limits.

Directors of public companies previously assumed that their company's D&O policy provided adequate protection. They took primary comfort from corporate bylaws that generally required advancement of their legal expenses and provided for broad indemnification in the event of a claim against them. Insurance provided an additional backstop against personal exposure. Outside directors were rarely charged individually, few were ever held liable for damages and most cases settled without personal contributions.

Within the last five years, however, directors have witnessed comprehensive reform in the Sarbanes-Oxley Act and securities markets listing rules requiring director independence, heightened enforcement activity by the SEC and Department of Justice, intense scrutiny of executive compensation, numerous lawsuits and investigations arising out of stock option backdating and the recent onslaught of credit crisis related litigation.

This environment, together with a large number of public company insolvencies, has increased the perceived need for stand-alone coverage for officers and directors—and, more recently, for standalone coverage dedicated to independent or outside directors. "Side A" D&O insurance was an effort to indemnify directors and officers when the corporation is either financially unable to indemnify its directors and officers, or prohibited from doing so. Side A coverage for non-indemnifiable losses gives directors and officers some comfort that their personal assets are not at risk in today's volatile environment. However, such policies—

like D&O coverage generally—do not guarantee that designated coverage will be available to protect independent or outside directors, as well as corporate insiders.

There is increasing interest by independent directors in coverage that protects only a company's independent or outside directors, not its officers. Independent Director Liability ("IDL") insurance—which can be standalone or excess of one or more standard Side A policies—provides a limit of liability that is not eroded by losses incurred by officers and, therefore, provides valuable additional protection for independent directors. In this Client Alert, we discuss the origin of IDL Insurance and why it may be a useful tool for both attracting high quality independent directors, and as a means of protecting and retaining the best talent.

The Evolution of Coverage for Directors and Officers

In the mid-1990's, most insurers drafted D&O Insurance policies to provide companies with direct protection for securities claims along with the traditional protection for directors and officers. While "entity" coverage—coverage for the company itself—eliminated the problems arising from the allocation of loss between insured individuals and an uninsured entity, it potentially had the adverse effect of diluting the insurance afforded to insured persons because many policies did not prioritize between insured individuals and the entity, and the entity's defense cost "burn rate" often substantially eroded the policy limits—thereby imperiling the insured individuals. Policy rescission and corporate bankruptcy issues could further impede insured individuals' access to this insurance asset.

Large-scale corporate meltdowns, and defense of the attendant private litigation often involving separate representation for individual insureds, results in a policy "burn rate" that substantially erodes policy limits for all insureds. Defense costs incurred by corporate insiders often eclipse those incurred by independent or outside directors, quickly eroding a valuable insurance asset and placing the personal assets of outside directors at risk.

These harsh realities led to a demand for products offering better coverage for directors and officers. "Side A" Insurance policies are one response to this problem—policies that covers only directors and officers—typically in excess of traditional D&O Insurance. However, although Side A coverage eliminated bankruptcy concerns and some of the dilution effects of entity coverage, such policies did not ensure that coverage would ultimately be available for independent directors.

IDL Insurance was created to remedy that very problem. While a close cousin to D&O Insurance, IDL Insurance provides coverage only for independent or outside directors and does not cover inside directors, officers or other employees. Because an IDL policy will likely have fewer and narrower exclusions, the policy should respond if, for example, the D&O insurer has limited or declined coverage based on a coverage defense that is not available under the broader terms of the IDL policy, the D&O insurer has become insolvent,

the D&O policy's limits have been fully exhausted, the D&O policy has been rescinded because or alleged misrepresentations, or payments under the D&O policy have been stayed by a bankruptcy court.

What Should an Independent Director Look For in an IDL Insurance Policy?

IDL insurance may be purchased by companies or by individual directors themselves—either as a stand-alone policy, or as an enhancement to a D&O Insurance policy. It is intended to serve as "an umbrella" for independent directors to ensure that there is coverage if a company's D&O policy fails for some reason. The degree to which IDL insurance reduces the risk of exhausting policy limits depends on the number of independent directors insured under any IDL policy. For example, IDL Insurance may cover independent directors on a board, one or more committees of a board, one independent director on a board, or one independent director for all the boards upon which he or she serves. The more independent directors who are covered under one plan, the greater the potential risk that coverage may not be sufficient.

Similar to D&O and Side A coverage, there is no standardized IDL Insurance policy form. It is therefore crucial to thoughtfully consider the terms, conditions, limitations and exclusions of an IDL policy—as well as the terms, conditions, limitations and exclusions of any other components of the company's D&O program—in order to ensure the greatest benefit for independent or outside directors. IDL policies typically have fewer and narrower exclusions than a standard D&O or Side A policy. For example, some IDL policies do not contain any fraud or illegal personal profit exclusions.

The increasing size of class action settlements and frequency of partial settlements— pursuant to which some defendants settle claims but others continue to face exposure— heighten the need for specialized coverage for directors and officers. As epitomized by the Enron D&O settlement, the proceeds of a standard D&O policy may be used to settle the claims against some Insureds without settling the claims against other Insureds—leaving those Insureds with little or no insurance to defend and settle the claims against them. The separate IDL limit of liability allows independent directors to focus their attention upon their corporate responsibilities, rather than potential exposure attendant to their positions, and enables companies to recruit and retain the best talent.

Baker & McKenzie International is a Swiss Verein with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

©2008 Baker & McKenzie
All rights reserved.