AKO EXECUTIVE INSURANCE ALERT

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# Lessons From The Enron Disaster: "Whose D&O Insurance Is It Anyway?"

By William G. Passannante and Marshall Gilinsky

The much talked-about implosion of Enron has plaintiffs' securities lawyers licking their chops, and likely will send the former energy giant, and its directors and officers, running for cover — and insurance coverage. Similar problems, in type if not magnitude, likely will be faced by numerous other companies and executives after Enron. As reported recently, "some . . . investors are concerned that other bombs like Enron's may be ticking, but that investors will have little help in spotting them before they blow." Gretchen Morgenson, "A Bubble That Enron Insiders and Outsiders Didn't Want to Pop" *The New York Times*, Jan. 14, 2002.

Any time that a company or its directors are faced with claims and law suits at the same time the company is filing, or is considering filing for bankruptcy, an important question is raised: *who comes first when accessing the D&O liability insurance coverage — the bankruptcy estate or the individual directors and officers?*

## *D&O Liability Insurance Covers Wrongful Acts*

Under a D&O insurance policy, the insurance company promises to indemnify, or pay on behalf of, the directors or officers all "Loss" that those individuals become legally obligated to pay for a "Wrongful Act" committed in their capacity as an officer and director. "Loss" is defined in the policies and generally includes any amounts paid in judgment or settlement, as well as the costs of defense. "Wrongful Act" generally is defined to include any negligent act, error or omission, or breach of duty committed by the directors or officers in the discharge of their duties and solely in their capacity as directors and officers. This promise, referred to as Coverage A, operates in favor of individual directors and officers.

Under Coverage B, the insurance company agrees to reimburse the corporate policyholder for all Loss that the company is required to indemnify, or has legally indemnified, the directors or officers for a claim alleging a Wrongful Act. Coverage B does not insure claims brought directly against the corporation.

Increasingly, D&O policies in the United States also include limited "Entity Coverage." Under such a policy, the insurance company agrees to reimburse the corporate policyholder for liability arising out of certain types of claims made against the corporate "entity", such as claims brought by investors under the securities laws, or for employee liabilities. However, Entity Coverage may reduce the limits available to protect the individual officers and directors.

## *D&O Liability Insurance in Bankruptcy*

In the event of a bankruptcy, D&O insurance that covers both the company and the individual directors is both: (1) a potentially crucial asset of the bankruptcy estate; and (2) a primary source of protection against invasion of the individual directors' personal assets. In such situations, disputes over this coverage do arise. The law regarding the question: "who has priority?" is not settled.

The United States Court of Appeals for the Fifth Circuit has held that the bankrupt estate did not have exclusive rights to a standard D&O policy's

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proceeds. *See In re Louisiana World Exposition, Inc.*, 832 F.2d 1391 (5th Cir., 1987). In *Louisiana World Exposition*, creditors of a bankrupt company attempted to seize the proceeds of the company's D&O insurance policy, thereby preventing the payment by the D&O insurer of defense costs incurred on behalf of the individual directors and officers. The court denied the creditors' request, noting that although the bankrupt company owned the policy, it did not own the policy proceeds. Accordingly, the court held that the liability proceeds payable to the insured directors and officers are not part of the company's bankruptcy estate.

Eight years later, in I*n re Vitek, Inc.*, 51 F.3d 530 (5th Cir. 1995), the Fifth Circuit acknowledged a distinction to its conclusion in *Louisiana World Exposition* where the policy provided direct coverage to the company itself: "Faced with the typical situation in which a debtor corporation's liability policies provide the debtor and thus the estate with direct coverage against third party claims, virtually every court to have considered the issue has concluded that the policies and clearly the proceeds of those policies are part of debtor's bankruptcy estate, irrespective of whether those policies also provide liability coverage for debtor's directors and officers." *In re Vitek*, 51 F.3d at 534.

The United States Court of Appeals for the Ninth Circuit has drawn a similar distinction. Compare *In re Pintlar Corp.*, 124 F.3d 1310 (9th Cir. 1997) (D&O policy not an asset of the estate where direct coverage belonging to the corporate policyholder was not implicated by the underlying action against the directors and officers) with *Minoco Group of Companies, Ltd. v. First State Underwriters Agency of New England Reinsurance Corp.*, 799 F.2d 517 (9th Cir. 1986) (D&O policy held an asset of the estate where indemnity coverage belonging to the corporate policyholder rendered the estate more valuable with the policy than without it).

### *Preparing for the Future*

When determining who comes first, a number of factors should be analyzed, including: (1) against whom claims are made; and (2) what coverage is provided under the policies. Disasters, such as that facing Enron, are often a rallying point for others to focus on protection — including insurance. Accordingly, directors, officers and other executives should keep these factors in mind when assessing the complex insurance implications raised, for the company's sake as well as their own. ■


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