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When Oil Prices Drop, Make Sure Your Insurance Tank Is Full

Law360, New York (July 8, 2016, 4:18 PM ET) --

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What do low energy prices have to do with directors and officers insurance? Notwithstanding a recent uptick, low prices have adversely affected the balance sheet of many oil and gas companies. Investors will scrutinize the decisions made by management — and in some cases will sue, alleging negligence, breach of fiduciary duty or worse. Such disputes could trigger coverage and payments from D&O insurance. If you face a contracting marketplace, be sure you have the right D&O coverage and make sure you get what you are supposed to get from that coverage.

It's not hard to see what the oil and gas industry faces as a result of the extended drop in oil prices. In recent years, we've seen how this plays out in other sectors of the economy. Amid the 2008 financial crisis, as investment values plummeted, hedge funds faced redemption demands from investors. Corporate directors and officers faced liability for their actions or omissions. The contraction in the marketplace put so much strain on investors that they found it worth their while to assert claims, whether legitimate or not, against management.

Oil patch companies face great difficulty. According to Alix Partners LLP, early this year U.S. shale producers were losing more than $2 billion weekly[1]. Under such conditions, eventually they will either be acquired or be bankrupt. Under either scenario, investor expectations will not be met and claims alleging liability on the part of management could follow. The D&O liability implications are clear. An investor will demand money and will sue the company, its officers and/or its directors. This could trigger coverage under the company's D&O policy.

Meanwhile, D&O insurers are likely to rely on hackneyed references to things that are excluded under the policy. You can expect that the exclusions for "ill-gotten gains" or "profit to which the insured was not legally entitled" will be asserted. But remember that until (and unless) a final adjudication conclusively establishes all of the conditions necessary for the exclusion to apply, coverage is available. That coverage would include the cost to defend the company and/or its officers/directors against the claims all the way through to a final, nonappealable judgment. The insurance company is obligated to pay for the company's cost of defending and indemnifying its officers and directors.

Shareholder Derivative Suits: Standing and Duty to Defend

A shareholder derivative action allows shareholders to bring suit against the directors and officers of a company. As in any lawsuit, the individual or individuals must possess standing to file such a lawsuit. The

Delaware Code requires that a plaintiff in a derivative suit must have been a stockholder in the corporation at the time that the alleged wrong took place. The plaintiff must swear to this in his or her complaint. 8 Del. C. § 327. See also, Schreiber v. Carney, 447 A2d 17, 21 Del Ch 1982.

The lone requirement enunciated in the Delaware Code is that the plaintiff be a stockholder. As case law has evolved, however, the Delaware Court of Chancery has recognized additional implicit prerequisites to bringing a derivative suit. Because the plaintiff represents the entire class of shareholders, he or she "must be qualified to serve in a fiduciary capacity as a representative of a class, whose interest is dependent upon the representative's adequate and fair prosecution." Youngman v. Tahmoush, 457 A2d 376, 379 (Del Ch 1983).

With regard to liability for transactions alleged to harm the company, one must remember that officers and directors are protected by the business judgment rule. Generally, this rule serves to insulate directors and officers from liability if the director or officer can show that he or she is not interested in the transaction, is informed as to the transaction such that he or she reasonably believes the transaction to be appropriate under the circumstances, and reasonably believes that the transaction is in the corporation's best interests. See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Volume 1, § 4.01 (2005). Further, in Delaware, director liability for breach of the duty of care is based upon a standard of gross negligence. TVI Corp. v. Gallagher, 2013 Del. Ch. LEXIS 260, at *41 (Ch Oct. 28, 2013, No. 7798-VCP). "[M]erely alleging that the defendants made poor business decisions does not rebut the business judgment rule or state a claim for breach of the duty of care." Id. Thus, while the business judgment rule by no means is a bar to a shareholder derivative suit, it can present a significant hurdle to stating a claim against a corporation's officers and directors.

The company is usually obligated to defend and indemnify its officers and directors based on commitments set forth in the company's organizational documents, such as bylaws, articles of incorporation and contractual agreements with management. Those agreements typically promise protection "to the fullest extent permitted by law." In Sun-Times Media Group Inc. v Black, 954 A2d 380 (Del Ch 2008), the Delaware Chancery Court held that obligation to include payment for the defense of a board member who had been convicted and sentenced for felony corruption while serving as CEO. The company's obligation to defend the felon continued all the way to the point of a final, nonappealable conviction and incarceration.

Even after a guilty plea, a corporate officer still may be entitled to defense and indemnification. In the criminal action underlying the coverage proceeding in Bergonzi v. Rite Aid Corp., 2003 Del. Ch. LEXIS 117, Bergonzi had entered a plea of guilty to participation in a criminal conspiracy to defraud Rite Aid while acting as its chief financial officer. Because the trial court made no determination regarding Bergonzi's right to indemnification, this potential right was preserved past the criminal proceedings until a court of competent jurisdiction determined his right, or lack thereof, to indemnification. As in Sun-Times, defense obligations continued through this period as well.

The cost of defending management against investor claims can be enormous. "Indeed, simply the cost of successfully defending [a breach of fiduciary duty] case can result in catastrophic financial losses for the director, so that insurance is necessary in that regard." 9-110 New Appleman on Insurance Law, Library Edition § 110.01. If the claims include a "fraud on the market" theory for publicly traded entities, the U.S. Supreme Court's recent decision in Halliburton Co. v. Erica P. John Fund Inc., 134 S Ct 2398 (2014) confirms that the litigation will be large and expensive. If D&O coverage is implicated, then the high cost of defense necessarily brings a quantum of value to the policyholder and the prospect of funding a settlement with the insurance company's cooperation.

Industry tumult could have long-lasting implications for oil patch companies, including their officers and directors. These implications could pass through to their D&O insurance companies. As shareholder discontent rises, so will the potential for coverage of director and officer liability under their policies.

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[1] Bradley Olson and Sarah Kent, Oil Slump Sets Scene for Mergers, The Wall Street Journal, January 29, 2016

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