A LOOK AT DIRECTORS AND OFFICERS INSURANCE POST-ENRON

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APRIL 23, 2002

The Enron bankruptcy has raised issues concerning the scope and effect of Enron's directors' and officers' liability insurance policies ("D&O policies"). Specifically, Enron creditors sought to bar Enron's directors and officers from accessing $350 million worth of D&O policy proceeds, arguing that the policy proceeds should instead be paid into the Enron bankruptcy estate. While the Enron creditors did not succeed in this initiative, the dispute created months of uncertainty about the Enron directors and officers' ability to access D&O insurance coverage and to obtain a defense against lawsuits filed by shareholders and retirement plan members. This memorandum analyzes why the Enron directors and officers found themselves in this dispute and how individuals who serve as corporate directors or officers may avoid their dilemma.

The Enron directors and officers' dispute over insurance proceeds arises from the fact that their D&O policies provide "entity coverage" as well as traditional directors and officers coverages. Historically, D&O policies provided: (i) liability coverage payable directly to directors and officers; and (ii) indemnity coverage to reimburse the policyholder corporation for any indemnification provided to its directors and officers. Traditionally, the policies covered "Wrongful Acts" committed or allegedly committed by the directors or officers, but not by the policyholder corporation (the "Insured Organization") itself.

In recent years, however, D&O insurers have offered "entity coverage" as part of the standard D&O policy. "Entity coverage" protects the Insured Organization against losses arising from its own acts.

By purchasing "entity coverage," a corporation becomes an insured under the D&O policy. This creates potential questions about the order in which payments are to be made to the various entities insured by the D&O policy. For example, a lawsuit may be commenced against the individual directors and officers and the corporation, alleging Wrongful Acts by both. If the claim is large enough to surpass the limits of the D&O policy, there may be a dispute between the directors and officers and the corporation (and shareholders) vis-à-vis the amount of coverage to be collected by each party. Some D&O policies attempt to resolve this issue by including an "order of payments" provision. *See* Rider A.

As the Enron situation demonstrates, the issue of priority of payments becomes particularly complicated when the Insured Organization seeks bankruptcy protection. When there are shared limits of coverage under the D&O policy (with directors and officers and the

Insured Organization entitled to the same pool of funds), creditors can assert that the proceeds of the D&O policy are property of the bankruptcy estate and invoke the automatic stay provisions of the Bankruptcy Code to prohibit directors and officers from accessing the policy proceeds. In essence, creditors can argue that absent a contractual priority provision, the directors and officers are precluded from recovering D&O proceeds ahead of the bankruptcy estate. Whether an "order of payments" provision would hold up in the bankruptcy setting has not yet been tested, but it could create greater leverage for directors and officers seeking prompt defense cost reimbursement.

Given the foregoing, directors and officers should review the D&O policies under which they are insured to determine whether: (a) the policies provide entity coverage, and (b) defense costs are paid as part of the policy limits. If these conditions exist, then the directors and officers may be at risk in the event of a bankruptcy filing by the Insured Organization. As in Enron, the directors and officers may find themselves in the middle of a dispute over whether defense costs may be paid out to them or must be preserved for the bankruptcy estate. This problem may be alleviated if the D&O policies provide a mechanism for prioritizing payments such that directors and officers are paid first, irrespective of the insolvency of an Insured Organization. However, to the extent there is any uncertainty or ambiguity regarding the payment of shared policy proceeds, the policies should be amended to include: (i) an order of payment provision; (ii) a sublimit of liability for entity coverage; and/or (iii) a provision requiring the insurer to pay defense costs in addition to policy limits (such that there is no erosion of the coverage available to the Insured Organization). Alternatively, the Insured Organization may purchase separate policies for the entity on one hand, and the directors and officers on the other.

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RIDER A

Model "Order of Payments" Provision

In the event of Loss arising from a covered Claim for which payment is due under the provisions of this policy, then the Insurer shall in all events:

(a) first, pay Loss of a natural person Insured for which coverage is provided under [the individual liability parts of] this policy; and then

(b) only after payment of Loss has been made pursuant to Clause (a) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, at the written request of the Insured Organization, either pay or withhold payment of such other Loss for which coverage is provided under the [corporate indemnification coverage part of this] policy; and then

(c) only after payment of Loss has been made pursuant to Clause (a) and (b) above, with respect to whatever remaining amount of the Limit of Liability is available after such payment, at the written request of the Insured Organization, either pay or withhold payment of such other Loss for which coverage is provided under [the entity coverage parts of] this policy.

The bankruptcy or insolvency of any Organization and/or entity Insured and/or any Insured Person shall not relieve the Insurer of any of its obligations to prioritize payment of covered Loss under this policy pursuant to this Clause.