The Entity Clause in Directors and Officers Insurance

August 6, 2002

We are advising our clients to review their Directors and Officers Insurance policies. In the last five years or so, a Trojan Horse has slipped into the standard policy, the full implications of which were not, in our opinion, fully considered. The problem is the so-called "entity clause" that has made its way into most policies.

The Problem: The "Entity Clause"

General.
An entity clause provides that the corporation is covered along with the directors and officers under the D&O policy for any act or omission for which the directors or officers are covered. Return to Index

History.
It was believed that extending coverage to the corporation itself was needed because the corporation almost always wound up as a co-defendant with the directors and officers in any securities claim. When only the directors and officers were covered, and the suit was settled under policy limits (as usually happens), a difficult struggle typically ensued over how to allocate the contributions to the settlement amount between the directors and officers and the corporation.

- Generally, insurance companies took the position that the directors could be proven at trial only to have played a minor part, if any at all, in the wrongdoing, and insurance would therefore only contribute a small percentage to the overall settlement.
- Settlements were hard to reach because the corporation would be required to come up with the lion’s share of the cost of settlement, and the corporation had no insurance.
- Insurance companies were also aggrieved that the corporation was getting a free ride on legal fees under the old system.

Thus, the “entity clause” made its appearance.

Benefit of entity clauses.
An entity clause is beneficial to directors and officers as long as the corporation is solvent, because it does indeed make it easier to get rid of securities claims by settlement.

Danger of entity clauses.

The danger of “entity clauses,” however, arises in insolvency situations. *Because the possible insolvency of the corporation is the principal reason to have D&O insurance in the first place, this danger is a matter of real concern.*

A case in point. The problem was made clear in a development in the Enron bankruptcy proceedings. In that case, Enron’s D&O carrier asked for a ruling from the bankruptcy judge permitting it to pay a $20 million advance for legal fees on behalf of Enron’s directors and officers. Enron’s creditors opposed the motion, arguing that

- under the entity clause in Enron’s policy, Enron was entitled to the proceeds of the policy to the extent not used by the directors and officers,
- Enron’s directors and officers would be required to reimburse Enron for advances of legal fees if it were later determined they had committed acts not covered by the policy,
- based on the Report of the Special Committee of Enron’s Board, it appeared that some of the directors or officers of Enron would not be entitled to have all of their defense costs paid by insurance, and
- given the magnitude of investor losses, it was unlikely that any individual director or officer would be able to repay such amounts.

Therefore, the creditors asserted that no payments should be made until subsequent court rulings clarified the situation. This motion, if granted, would have eviscerated the D&O policy.

Competition of creditors with directors and officers. *Thus, what "entity clauses" do is to place creditors of an insolvent corporation into competition with the directors and officers for the proceeds of D&O policies.* We feel certain that this result is not the expectation of your directors.

Even though the bankruptcy judge in the Enron proceedings ultimately permitted the first $20 million advance to be paid, we feel that the position taken by the creditors represents a serious threat to the efficacy of D&O insurance.

Renewal of D&O Policies

Renewal. Renewal is a fluid situation. Insurance agents tell us that renewals of D&O policies

- are going to be much more expensive,
- provide less coverage,
- have higher retentions and
- may include co-insurance obligations.

These are market-driven responses, and there is little corporations can do about it. The "trojan horse" problem that we have discussed above, however, should be addressed as soon as possible, independently of the overall renewal problem. Insurance agents recommend that companies complete the application, in detail, well in advance of the renewal deadline so that the company has time to negotiate coverage and other provisions.

A Solution: Order of Payment Endorsement

Order of Payment Endorsements.

We believe that the best fix for the "entity clause" problem in bankruptcy at this point in time is the introduction of an "order of payment" endorsement, which we understand insurers are willing to grant essentially without cost. These riders provide that

- the proceeds of the policy are paid first to directors and officers;
- next, to the corporation to reimburse it for any indemnification payments it may have made to directors and officers; and
- last, to the extent any funds may be left over, to the corporation for any liability it may have for covered acts or omissions.

Effects of order of payment clauses.

These clauses typically say that bankruptcy of the corporation has no effect on the carrier's duty to observe the order of payment agreed upon. Provided they are enforceable in bankruptcy (bankruptcy judges have wide equitable powers), these clauses solve most of the problem. It is worth bearing in mind that order of payment clauses would not relieve directors of payment of the retention amounts personally in a bankruptcy context.

Examine your D&O policy.

Although only time will tell, our bankruptcy lawyers believe that order of payment clauses are likely to be upheld by bankruptcy judges except in egregious fact situations. The wording of these endorsements must be carefully negotiated, however. We recommend that you examine your D&O policy as soon as possible. We are available to help.

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