INSURANCE ADVOCATE

A NEW FORM OF ENDANGERED SPECIES?

by PHIL ZINKEWICZ

Let's say you're a business executive who has recently retired, but you want to stay close to the world of entrepreneurial endeavors. You want to keep your hand in, so to speak. What better way than to accept a position on the board of directors of a company. You make a few extra dollars. But more importantly, you have prestige. You can mingle with the president of the company, the chief financial officer. Every couple of weeks, you get a free lunch or dinner at a fancy restaurant or an impressive board room. What better way to while away the sunset years, in between travel and fishing?

Or, let's say you're a young, but promising executive. You want to fill your resume out as much as possible. You want to make contacts. You accept membership on a board, so that you can have it listed on your letterhead. All you have to do is cast a vote now and again, and, if you vote with the majority of more experienced members, what can you lose?

The answer is, a great deal. The Enron situation has called into question the responsibilities of directors and officers of corporations. It has placed a spotlight on all those members of an organization who are decision-makers. Moreover, it is a test case for the entire directors' and officers' insurance marketplace, according to Roger Barton of the New York law firm of Barton Barton and Plotkin.

"The officers of a company are responsible for the operations of a company. But directors are responsible for oversight of the company," said Barton in an interview with the Insurance Advocate. "That begs the question, how do you define oversight? Directors have to exercise their duty of care to demand information that keeps them fully informed. Just saying, 'I didn't know," is not exercising that duty of care and is not a sufficient defense in a D&O lawsuit."

There are allegations of fraud in the Enron inquiry. If directors were misled, or actually defrauded by those operating the company, is that a defense? Here again, Barton said there are gray areas. Did a director do everything "reasonably possible" to accumulate information that might have detected fraud or improper behavior? If that director did do everything "reasonably possible" in the eyes of the courts, then he or she has a legitimate defense. But that begs another question, what is "reasonable?"

There is no question in Barton's mind that the Enron situation is going to discourage people, even qualified people, from accepting positions on corporate boards. "I'd say that it is 110 percent correct to assume that executives will be shying away from board positions," he said. "It has always been difficult to get board members to sit on audit committees. However, now, given the Enron situation, people will be much more wary about sitting on a board at all."

Then there is the question of D&O coverage itself. The very concept of the insurance product may be called into question because of Enron, according to Barton. Right now, surety insurers

are involved in litigation in New York Bankruptcy Court, seeking to get out from under surety claims alleging that they were misled by Enron executives as to the business dealings they had contracted to perform. It is not beyond the realm of possibility that D&O insurers might take the same route.

"If D&O underwriters want to continue in the D&O market, then they will have to either make good on the claims or prove that they were intentionally misled or lied to," says Barton. "But that might be a hard road to hoe. Underwriters would have to prove that they took every step in the underwriting process to demonstrate they were acting under 'reasonable reliance' in underwriting the risk. They were responsible under due diligence laws to make their own risk assessment — i.e. conducting analyses of possible lawsuit situations and conducting their own audits before underwriting the risks.

The question they have to answer in the courts, Barton said, is: 'Was it reasonable to rely on information from Enron's in the underwriting process?' If the courts decide that it was reasonable, then the underwriters will win, and they can allege that they were misled or were defrauded. In that case, there will be no D&O insurers that claimants can tap into. If the courts decide that underwriters should have dug further and didn't do their jobs properly, then they could be on the hook for the D&O claims."

Barton said that the entire situation regarding Enron boils down to judgment. What did directors of the companies know, or what should they have known? How much "judgment" is required of a director of a company when voting on a particular course of action? What if one director stands apart from the majority when a vote is taken? What are that director's options? Should he or she go along with the majority and face the possibility of a D&O lawsuit if an Enron-type situation results, or should that director make an appeal to a responsible executive of the company or, in a last resort, resign?

And what about the D&O insurers? If they can demonstrate to the courts that they operated under "reasonable reliance," can they, without impunity, walk away from the claims of shareholders and employees, who have been financially injured? What are their options? Without D&O insurance coming into play for their claims, can they sue directors and officers of the company individually to recoup their losses? That would be a time-consuming and costly litigation process with no guarantees.

And what about Arthur Andersen? To what extent is the independent auditing firm liable for the losses of so many? Barton said that the accounting firm may be hit with accounting malpractice lawsuits or errors and omissions lawsuits because of allegations that the firm failed to disclose allegedly bogus partnerships with Enron.

Some things are certain to come out of the Enron situation, according to Barton. First, he said, there will be changes in accounting rules and laws. Off-balance sheet liabilities will become a thing of the past, he said. In addition, there will have to be laws defining clearly what are the responsibilities of directors and officers of a company. "Directors and officers liability insurance is intended to protect those insured against negligence, not intentional wrong doing or failure to perform their tasks diligently," Barton said.

Undoubtedly, Barton is correct. Because of Enron, the days of people accepting board membership merely to feather their own nests or to fill time in retirement years are gone. From now on, there will be a demand for greater accountability on the part of directors. In addition, if the directors and officers liability insurers are to establish credibility, they will have to demonstrate that they are making every effort in the underwriting process to understand fully the exposures they are taking on.

Fraud has not yet been proved in the Enron debacle. But even if it isn't, what has been proven is that the "suits" in the world of big business have not done their jobs properly, and the ones paying the price are the shareholders and employees who put their trust in executive leadership.

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