

Implications of Demands for Personal Contributions to Securities Settlements by Defendant D&Os

First WorldCom, now Enron – institutional lead plaintiffs are increasingly demanding that individual defendants pay out of their own pockets for corporate frauds. Most alarming about this trend is that the institutional plaintiffs are seeking personal contributions not just from the insiders who orchestrated the corporate frauds, but also from the outside directors who failed to detect and correct the fraud. And the outside directors are digging into their pockets and paying: \$18 million in the case of several WorldCom outside director defendants as part of a \$54 million settlement, and reportedly as much as \$13 million as part of a \$200 million settlement on behalf of the outside directors of Enron.

Are two cases enough to suggest a trend in securities settlements? It may well be too early to tell. Also, these cases are arguably unique as corporate meltdowns due to the scope of the corporate fraud and the size of the market capitalization loss, but they do present a cautionary tale not to be ignored. Given these settlements and other trends we have been observing in securities litigation and settlements generally, we offer below some predictions for what D&O insurers may see in future securities class action settlements. But first, let's look at some of the key details of the WorldCom and Enron settlements.

The WorldCom Outside Directors Settlement

The stipulation of settlement among the WorldCom class action plaintiffs, the settling WorldCom director defendants and the various WorldCom insurers provides for a \$54 million payment to the settlement class, to be funded two-thirds (\$36 million) by the insurers and one-third (\$18 million) by the settling director defendants. The directors have represented that the collective payment of \$18 million constitutes approximately 20 percent of their cumulative net worth, excluding primary residences, retirement accounts and judgment-proof joint assets.

The Enron Outside Directors Settlement

The Enron outside directors settlement provides that the Enron D&O insurers agree to interplead the remaining limits of liability of \$200 million. (The first \$150 million of the \$350 million of the overall Enron D&O program was already paid out in defense expenses.) The Creditors' Committee receives 17.2 percent or \$34.4 million of the settlement and the plaintiffs receive the balance, 82.8 percent or \$165.6 million. The plaintiffs also receive 10 percent of the net Enron stock sales proceeds from the outside directors during the class period, estimated in press reports as \$13 million. From the \$165.6 million, \$16 million is carved out for the ongoing defense costs of the non-settling defendants. The lead plaintiff may, at its option, seek a ruling on the submission of proportionate fault.

Observations:

- Although we have not yet seen frequent manifestation of this behavior, it appears now that when the decision makers at institutional investment organizations – such as state or city pension plans – have a political orientation, there may be other factors at play. Unlike truly private plaintiffs, who are primarily concerned with obtaining recovery for demonstrated investor losses, the status of lead plaintiff in a well-publicized corporate scandal for a public or quasi-public official provides an opportunity for press conferences, press releases and future campaign resume fodder. For these lead plaintiffs, pennies-on-the-dollar recoveries for alleged investor losses are not enough. Thus, these lead plaintiffs will look for opportunities to demonstrate that they are deterring corporate fraud and making investments safer for investors. Whether or not deterrence is a legitimate goal of a private plaintiff is beside the point: the presence and unique motivations of institutional investor lead plaintiffs are direct results of the reforms sought in the Private Securities Litigation Reform Act of 1995 (the “PSLRA”), and we now live with those consequences – good or bad.
- In an article entitled “Directors are Getting the Jitters,” which appeared in the January 13, 2005, edition of *The Wall Street Journal*, that paper reported that the State of Wisconsin Investment Board, in at least one case, paid five extra contingency percentage points to its law firm for obtaining personal recoveries from the individual defendants. Needless to say, this is a powerful incentive for plaintiffs’ lawyers to seek personal recoveries.
- Even where no such additional contingency income is promised, however, a threat by plaintiffs’ lawyers to later seek a personal contribution from defendant directors and officers may be sufficient to motivate defendants to demand that their D&O insurers fund early settlements of securities class action cases – whether or not the settlement demands are reasonable. Of course, it remains to be seen whether politically-motivated institutional plaintiffs would be amenable to allowing the outside directors to extricate themselves by way of an early settlement with only insurance proceeds. If the plaintiffs’ posture is going to always be “insurance money plus,” that will chill the directors’ ardor for an early settlement.
- Payments from the outside directors is not the whole story. In the case of Enron, the \$350 million D&O program was shared by scores of defendants collectively fighting more than one hundred separate lawsuits. D&O policy proceeds of \$150 million already had been paid, and there was a reasonable risk that the entire D&O insurance program would be paid out in defense costs before the larger Enron lawsuits were even presented to a jury. Thus, by settling first with the outside directors, who are arguably the least culpable, the plaintiffs accomplished two things. First, they secured the remaining D&O insurance (plus the individuals’ contribution). Second, by obtaining the balance of the insurance program, the plaintiffs have left the remaining officer defendants with little resources with which to maintain a defense – other than a relatively nominal carve out of \$16 million from the D&O insurance program. With defense expenses of

nearly \$5 million per month, \$16 million is unlikely to go very far in covering all of the remaining officer defendants' ongoing expenses.

- Given the judicial incursions into the *Central Bank* ban on “aider and abettor” liability in securities cases, we can expect to see investment banks, accounting firms and outside lawyers increasingly involved as defendants in these cases, particularly in the larger corporate fraud cases. For this reason, we can expect to see this strategy of settling first with the outside directors repeated in other large securities cases, especially where the co-defendants have the resources to contribute substantial amounts to settlements. Because the outside directors presumably have the least proportionate liability, it is a logical strategy for the plaintiffs to settle with them first, and it is more likely where there are limited and dwindling insurance proceeds.

D&O Insurance Implications:

- One could argue that the Enron and WorldCom settlements should be considered unique and not part of any trend because the operative dynamic in both cases was the combination of a bankrupt corporate defendant and limited insurance proceeds and/or strong coverage defenses. However, we remain concerned that the driving factor in the outside director settlements may be the desire of institutional lead plaintiffs to point to tangible litigation victories and to claim the moral high ground in deterring corporate frauds. Despite similarities, there is one important distinction between the WorldCom and Enron settlements. The Enron settlement, coupled with previously paid defense costs, will entirely exhaust the program of D&O insurance. The WorldCom settlement apparently has not exhausted the insurance, presumably due to the strength of the insurers' rescission arguments set forth in pending litigation. Enron thus belies the comments of some commentators that the WorldCom insurance program was somehow “defective” in that it failed to make the entire proceeds available to settle. No amount of insurance coverage would have obviated the directors' need to pay in each of these cases in light of the plaintiffs' agenda. The insurers achieved a savings in WorldCom not due to any generosity on the part of the plaintiffs, but rather because they were themselves victims of misrepresentations by at least some of their insureds.
- Would Side A insurance help in these settlements? Not if one subscribes to the theory that no amount of insurance could have avoided the Enron and WorldCom settlement results. A similar dynamic is being played out in the mutual fund settlements with the New York Attorney General. Regardless of whether the insurance policies *could* provide coverage, a prosecutor or like-minded civil plaintiff can always try to exert whatever means it has to render some component or all of the settlement as having no recourse to insurance.
- What does all of this suggest for Independent Director Liability coverage (“IDL”), and should independent directors insist on separate coverage for their potential liability? If a lead plaintiff insists on obtaining a “personal contribution” from a director who funded a settlement through an IDL policy, the director may have a better argument that it constitutes a personal contribution if

he or she paid the premium personally. On the other hand, an insurance policy is an insurance policy, and a lead plaintiff who wants a personal contribution may object to an insurance-funded contribution, from whatever source.

Stay Tuned. . .

Viewed as part of a larger cycle, the spectacular Enron collapse in October 2001 could mark the beginning of a dramatic pendulum shift to a litigation environment where plaintiffs' attorneys, regulators (particularly state attorneys general) and institutional investors have found themselves on the same side of an alliance against large public corporations, investment banks and accounting firms. As in past cycles, that pendulum – characterized at this end by blatant examples of corporate fraud and irresponsibility – will eventually begin to move towards the center, and possibly, beyond that. What will be the signals of the next shift in the environment? Here are some developments worth watching:

- Several articles have been written about alleged pay-to-play arrangements between plaintiffs' lawyers donating to state and local political organizations and the public and quasi-public institutional organizations that hire those lawyers. If instances of corruption or bribery are unearthed, expect these institutional investors to shrink from visible lead plaintiff roles and renounce their relationships with plaintiffs' firms.
- Regulators look to tipsters to identify kinds and sources of wrongdoing. This presents a tempting opportunity for plaintiffs' lawyers to attempt to steer the regulators towards targets the plaintiffs' firms would like to sue or have regulated. A few wild-goose chases urged on by plaintiffs' lawyers may make the regulators much more cautious. Another unintended consequence for the plaintiffs may be that any settlement fund recovered by the regulators may well serve to offset, if not completely defeat, any potential recovery of damages by the plaintiffs in civil class actions.
- A string of successes by the plaintiffs' bar has the potential to result in a false sense of confidence and invulnerability. If there is anything the plaintiffs' bar should have learned from the wealthy and successful corporate defendants they have sued, it is that success often breeds arrogance, complacency and overindulgence. These vices, in turn, often invite litigation reform.

For Further Information

If you have any questions about the information in this Alert, please contact one of the members of the Duane Morris Insurance and Financial Products or Securities Practice Groups listed below or the lawyer in the firm with whom you are regularly in contact.

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